FIRST COMMUNITY CORP /SC/
Form 10-Q
November 10, 2011
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

x	**Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

for the quarterly period ended September 30, 2011

o	**Transition report pursuant to Section 13 or 15(d) of the Exchange Act**

for the transition period from to

Commission File No. 000-28344

FIRST COMMUNITY CORPORATION

(Exact name of registrant as specified in its charter)

South Carolina	**57-1010751**
(State of Incorporation)	(I.R.S. Employer Identification)

5455 Sunset Boulevard, Lexington, South Carolina 29072

(Address of Principal Executive Offices)

(803) 951-2265

(Registrant s Telephone Number, Including Area Code)

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

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No o

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

Large accelerated filer o	Accelerated filer o
Non-accelerated filer o	Smaller reporting company x

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

Indicate the number of shares outstanding of each of the issuer s classes of common equity, as of the latest practicable date: **On November 9, 2011, 3,303,519 shares of the issuer s common stock, par value $1.00 per share, were issued and outstanding.**

Table of Contents

TABLE OF CONTENTS

Table of Contents

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

FIRST COMMUNITY CORPORATION

CONSOLIDATED BALANCE SHEETS

(Dollars in thousands, except par value)	September 30, 2011 (Unaudited)	December 31, 2010
ASSETS		
Cash and due from banks	$ 9,465	$ 7,114
Interest-bearing bank balances	8,217	19,102
Federal funds sold and securities purchased under agreements to resell	305	245
Investment securities - available for sale	208,900	189,309
Other investments, at cost	5,984	6,841
Loans held for sale	5,195	
Loans	324,233	329,954
Less, allowance for loan losses	4,708	4,911
Net loans	319,525	325,043
Property, furniture and equipment - net	17,593	18,026
Bank owned life insurance	10,877	10,773
Other real estate owned	8,269	6,904
Intangible assets	793	881
Other assets	11,761	14,785
Total assets	$ 606,884	$ 599,023
LIABILITIES		
Deposits:		
Non-interest bearing demand	$ 84,857	$ 72,625
NOW and money market accounts	139,462	123,604
Savings	32,670	29,886
Time deposits less than $100,000	131,747	143,946
Time deposits $100,000 and over	84,424	85,283
Total deposits	473,160	455,344
Securities sold under agreements to repurchase	16,927	12,686
Federal Home Loan Bank advances	48,724	68,094
Junior subordinated debt	15,464	15,464
Other borrowed money	100	120
Other liabilities	5,809	5,518
Total liabilities	560,184	557,226
SHAREHOLDERS EQUITY		
Preferred stock, par value $1.00 per share, 10,000,000 shares authorized; 11,350 issued and outstanding	11,111	11,035
Common stock, par value $1.00 per share; 10,000,000 shares authorized; issued and outstanding 3,303,519 at September 30, 2011, 3,270,135 at December 31, 2010	3,304	3,270
Common stock warrants issued	509	509
Nonvested restricted stock	(39)	
Additional paid in capital	49,146	48,956
Accumulated deficit (loss)	(18,374)	(19,732)
Accumulated other comprehensive income	1,043	(2,241)

Total shareholders equity		46,700		41,797
Total liabilities and shareholders equity	$	606,884	$	599,023

See Notes to Consolidated Financial Statements

Table of Contents

FIRST COMMUNITY CORPORATION

CONSOLIDATED STATEMENTS OF INCOME

(Dollars in thousands, except per share data)	Nine Months Ended September 30, 2011 (Unaudited)	Nine Months Ended September 30, 2010 (Unaudited)
Interest income:		
Loans, including fees	$ 14,376	$ 14,970
Taxable securities	4,803	5,632
Non taxable securities	51	168
Federal funds sold and securities purchased under resale agreements	28	44
Other	30	28
Total interest income	19,288	20,842
Interest expense:		
Deposits	3,557	4,860
Federal funds sold and securities sold under agreement to repurchase	29	50
Other borrowed money	2,001	2,277
Total interest expense	5,587	7,187
Net interest income	13,701	13,655
Provision for loan losses	1,110	1,365
Net interest income after provision for loan losses	12,591	12,290
Non-interest income:		
Deposit service charges	1,376	1,421
Mortgage origination fees	1,152	691
Investment advisory fees and non-deposit commissions	531	416
Gain on sale of securities	274	324
Gain (loss) on sale of other assets	(109)	18
Fair value (loss) adjustments	(185)	(644)
Other-than-temporary-impairment write-down on securities	(54)	(799)
Loss on early extinguishment of debt	(74)	
Other	1,480	1,247
Total non-interest income	4,391	2,674
Non-interest expense:		
Salaries and employee benefits	7,002	6,610
Occupancy	953	918
Equipment	858	873
Marketing and public relations	361	301
FDIC assessments	681	735
Other real estate expense	638	536
Amortization of intangibles	466	466
Other	2,807	2,597
Total non-interest expense	13,766	13,036
Net income before tax	3,216	1,928
Income taxes	963	471
Net income	$ 2,253	$ 1,457
Preferred stock dividends	502	497
Net income available to common shareholders	$ 1,751	$ 960
Basic earnings per common share	$ 0.53	$ 0.29
Diluted earnings per common share	$ 0.53	$ 0.29

See Notes to Consolidated Financial Statements

Table of Contents

FIRST COMMUNITY CORPORATION

CONSOLIDATED STATEMENTS OF INCOME

(Dollars in thousands, except per share data)	Three Months Ended September 30, 2011 (Unaudited)	Three Months Ended September 30, 2010 (Unaudited)
Interest income:		
Loans, including fees	$ 4,747	$ 4,946
Taxable securities	1,600	1,755
Non taxable securities	18	91
Federal funds sold and securities purchased under resale agreements	7	17
Other	10	9
Total interest income	6,382	6,818
Interest expense:		
Deposits	1,114	1,555
Federal funds sold and securities sold under agreement to repurchase	11	13
Other borrowed money	629	767
Total interest expense	1,754	2,335
Net interest income	4,628	4,483
Provision for loan losses	360	235
Net interest income after provision for loan losses	4,268	4,248
Non-interest income:		
Deposit service charges	440	459
Mortgage origination fees	698	342
Investment advisory fees and non-deposit commissions	218	82
Gain on sale of securities	133	218
(Loss) on sale of other assets	(18)	(10)
Fair value (loss) adjustments	(60)	(201)
Other-than-temporary-impairment write-down on securities	(50)	(440)
Loss on early extinguishment of debt	(74)	
Other	401	472
Total non-interest income	1,688	922
Non-interest expense:		
Salaries and employee benefits	2,493	2,305
Occupancy	336	312
Equipment	287	290
Marketing and public relations	64	105
FDIC assessment	176	323
Other real estate expense	134	243
Amortization of intangibles	156	155
Other	912	911
Total non-interest expense	4,558	4,644
Net income before tax	1,398	526
Income taxes	441	132
Net income	$ 957	$ 394
Preferred stock dividends	167	166
Net income available to common shareholders	$ 790	$ 228
Basic earnings per common share	$ 0.24	$ 0.07
Diluted earnings per common share	$ 0.24	$ 0.07

See Notes to Consolidated Financial Statements

Table of Contents

FIRST COMMUNITY CORPORATION

Consolidated Statement of Changes in Shareholders Equity and Comprehensive Income (Loss)

Nine Months ended September 30, 2011 and September 30, 2010

(Unaudited)

(Dollars in thousands)	Preferred Stock	Shares Issued	Common Stock	Common Stock Warrants	Additional Paid-in Capital	Nonvested Restricted Stock	Retained Earnings (Deficit)	Other Comprehensive Income (Loss)	Total
Balance, December 31, 2009	$ 10,939	3,252	$ 3,252	$ 509	$ 48,873	$ (79)	$ (20,401)	$ (1,653)	$ 41,440
Comprehensive income:									
Net income							1,457		1,457
Other comprehensive income:									
Unrealized gain during period on available-for-sale securities net of tax of $732								1,341	
Less: reclassification adjustment for gain included in net income, net of tax benefit $113								(211)	
Reclassification adjustment for Other- than-temporary impairment included in income net of tax of $280								519	
Other comprehensive income								1,649	1,649
Comprehensive income:									3,106
Amortization of compensation on restricted stock						79			79
Dividends: Common ($0.12 per share)							(391)		(391)
Preferred	72						(497)		(425)
Dividend reinvestment plan		14	14		66				80
Balance, September 30, 2010	$ 11,011	3,266	$ 3,266	$ 509	$ 48,939	$	$ (19,832)	$ (4)	$ 43,889
Balance, December 31, 2010	$ 11,035	3,270	$ 3,270	$ 509	$ 48,956	$	$ (19,732)	$ (2,241)	$ 41,797
Comprehensive income:									
Net income							2,253		2,253
Other comprehensive income:									
Unrealized gain during period on available-for-sale securities net of tax of $1,806								3,427	
Less: reclassification adjustment for gain included in net income, net of tax benefit of $96								(178)	
Reclassification adjustment for Other- than-temporary impairment included in income net of tax of $19								35	
Other comprehensive income								3,284	3,284
Comprehensive income:									5,537
Issuance of restricted stock		23	23		133	(65)			91
Amortization of compensation on restricted stock						26			26
Dividends: Common ($0.12 per share)							(393)		(393)
Preferred	76						(502)		(426)
Dividend reinvestment plan		11	11		57				68
Balance, September 30, 2011	$ 11,111	3,304	$ 3,304	$ 509	$ 49,146	$ (39)	$ (18,374)	$ 1,043	$ 46,700

See Notes to Consolidated Financial Statements

Table of Contents

FIRST COMMUNITY CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

(Dollars in thousands)	**Nine months ended September 30, 2011**	**2010**
Cash flows from operating activities:		
Net income	$ 2,253	$ 1,457
Adjustments to reconcile net income to net cash provided in operating activities:		
Depreciation	634	667
Premium amortization	1,355	943
Provision for loan losses	1,110	1,365
Writedowns of other real estate owned	243	274
(Gain)loss on sale of other real estate owned	109	(19)
Amortization of intangibles	466	466
Gain on sale of securities	(274)	(324)
Loss on early extinguishment of debt	74	
Other-than-temporary-impairment on securities	54	799
Net decrease in fair value option instruments and derivatives	185	644
(Increase) decrease in other assets	520	(591)
Increase in other liabilities	292	574
Net cash provided in operating activities	7,021	6,255
Cash flows from investing activities:		
Purchase of investment securities available-for-sale	(91,464)	(100,532)
Maturity of investment securities available-for-sale	28,919	30,933
Proceeds from sale of securities available-for-sale	47,792	56,504
Purchase of investment securities held-to-maturity		(10)
Maturity of investment securities held-to-maturity		6,962
Decrease (increase) in loans	(4,535)	7,428
Proceeds from sale of other real estate owned	2,141	1,866
Purchase of property and equipment	(211)	(127)
Proceeds from sale of land	9	
Net cash provided (used) in investing activities	(17,349)	3,024
Cash flows from financing activities:		
Increase in deposit accounts	17,815	11,995
Increase (decrease) in securities sold under agreements to repurchase	4,241	(4,793)
Decrease in other borrowings	(20)	(44)
Advances from the FHLB	1,500	
Repayment of advances FHLB	(20,945)	(4,620)
Dividends paid: Common Stock	(393)	(391)
Preferred Stock	(502)	(497)
Dividend reinvestment plan	158	79
Net cash provided from financing activities	1,854	1,729
Net increase (decrease) in cash and cash equivalents	(8,474)	11,008
Cash and cash equivalents at beginning of period	26,461	20,844
Cash and cash equivalents at end of period	$ 17,987	$ 31,852
Supplemental disclosure:		
Cash paid during the period for:		
Interest	$ 5,967	$ 6,939
Income taxes	$	$
Non-cash investing and financing activities:		
Unrealized gain on securities	$ 3,284	$ 1,651

Transfer of loans to foreclosed property	$	3,694	$	6,339
Transfer of HTM securities with OTTI to AFS securities	$		$	5,800

See Notes to Consolidated Financial Statements

Table of Contents

First Community Corporation

Notes to Consolidated Financial Statements

Note 1 - Nature of Business and Basis of Presentation

First Community Corporation, a bank holding company registered under the Bank Holding Company Act of 1956, as amended (the Company), was incorporated under the laws of South Carolina in 1994 primarily to own and control all of the capital stock of First Community Bank, N.A. (the Bank), which commenced operations in August 1995. On October 1, 2004, the Company completed its acquisition of DutchFork Bancshares, Inc. and its wholly-owned subsidiary, Newberry Federal Savings Bank. During the second quarter of 2006, the Company completed its acquisition of DeKalb Bankshares, Inc., the holding company for The Bank of Camden. On September 15, 2008, the Company completed the acquisition of two financial planning and investment advisory firms, EAH Financial Group and Pooled Resources, LLC. The Company engages in a commercial banking business from our main office in Lexington, South Carolina and our 11 full-service offices located in Lexington (two), Forest Acres, Irmo, Cayce-West Columbia, Gilbert, Chapin, Northeast Columbia, Prosperity, Newberry and Camden. The Company offers a wide-range of traditional banking products and services for professionals and small-to medium-sized businesses, including consumer and commercial, mortgage, brokerage and investment, and insurance services. The Company also offers online banking to our customers. The Company s stock trades on The NASDAQ Capital Market under the symbol FCCO.

The Bank expanded its residential mortgage business unit with the acquisition of the assets of Palmetto South Mortgage Corporation (Palmetto South), effective July 31, 2011. Palmetto South, which operates as a division of the Bank, offers mortgage loan products for home purchase or refinance in the South Carolina market area. The acquisition price will be paid during a three year earn out period with the actual amount calculated based on the achievement of certain profitability metrics. The earn out terms over the three year period provide for contingent consideration which ranges from $0 to $1.2 million based upon annual net income. Management anticipates the amount will be approximately $600 thousand based upon recent past operating results. The purchase price of operating assets was $22 thousand.

In the opinion of management, the accompanying unaudited consolidated balance sheets, the consolidated statements of income, the consolidated statements of changes in shareholders equity and comprehensive income (loss), and the consolidated statements of cash flows of the Company, present fairly in all material respects the Company s financial position at September 30, 2011 and December 31, 2010, the Company s results of operations for the nine and three months ended September 30, 2011 and 2010, and the Company s cash flows for the nine months ended September 30, 2011 and 2010. The results of operations for the nine and three months ended September 30, 2011 are not necessarily indicative of the results that may be expected for the year ending December 31, 2011.

In the opinion of management, all adjustments necessary to fairly present the consolidated financial position and consolidated results of operations have been made. All such adjustments are of a normal, recurring nature. All significant intercompany accounts and transactions have been eliminated in consolidation. The consolidated financial statements and notes thereto are presented in accordance with the instructions for Form 10-Q. The information included in the Company s 2010 Annual Report on Form 10-K should be referred to in connection with these unaudited interim financial statements.

Table of Contents

Note 2   Earnings Per Share

The following reconciles the numerator and denominator of the basic and diluted earnings per share computation:

(In thousands, except price per share)	Nine months ended September 30, 2011	Nine months ended September 30, 2010	Three months ended September 30, 2011	Three months ended September 30, 2010
Numerator (Net income available to common shareholders)	$ 1,751	$ 960	$ 790	$ 228
Denominator				
Weighted average common shares outstanding for:				
Basic earnings per share	3,280	3,259	3,294	3,264
Dilutive securities:				
Stock options Treasury stock method				
Diluted earnings per share	3,280	3,259	3,294	3,264
The average market price used in calculating assumed number of shares	$ 6.45	$ 6.02	$ 6.19	$ 5.55

At September 30, 2011, there were 77,450 outstanding options at an average exercise price of $19.07 and warrants for 196,000 shares at $8.69. None of the options or warrants has an exercise price below the average market price of $6.45 and $6.19 for the nine and three-month periods ended September 30, 2011, respectively, and therefore are not

deemed to be dilutive. At September 30, 2010 there were 190,256 outstanding options at an average exercise price of $13.28 and warrants for 196,000 shares at $8.69. None of the options or warrants has an exercise price below the average market price of $6.02 and $5.55 for the nine and three-month periods ended September 30, 2010, respectively, and therefore are not deemed to be dilutive.

Note 3   Assets and Liabilities Measured at Fair Value

In connection with the adoption of the Fair Value Option, the Company adopted the requirements of the FASB ASC Fair Value Measurement Topic which defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. The Fair Value Measurement Topic also establishes a fair value hierarchy which 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 value:

Level l   Quoted prices in active markets for identical assets or liabilities.

Level 2   Observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 3 Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. Level 3 assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which the determination of fair value requires significant management judgment or estimation.

Table of Contents

Note 3 Assets and Liabilities Measured at Fair Value-continued

The following is a description of valuation methodologies used for assets and liabilities recorded at fair value on a recurring basis:

Investment Securities Available for Sale: Measurement is on a recurring basis based upon quoted market prices, if available. If quoted market prices are not available, fair values are measured using independent pricing models or other model-based valuation techniques such as the present value of future cash flows, adjusted for prepayment assumptions, projected credit losses, and liquidity. Level 1 securities include those traded on an active exchange or by dealers or brokers in active over-the-counter markets. Level 2 securities include mortgage-backed securities (MBSs) issued by government sponsored enterprises and private label MBSs. Generally these fair values are priced from established pricing models. Level 3 securities include corporate debt obligations and asset backed securities that are less liquid or for which there is an inactive market.

Loans: Loans that are considered impaired are recorded at fair value on a non-recurring basis. Once a loan is considered impaired, measurement is based upon FASB ASC 310-10-35 Loan Impairment . The fair value is estimated using one of several methods, including collateral liquidation value, market value of similar debt and discounted cash flows. Those impaired loans not requiring a specific charge against the allowance represent loans for which the fair value of the expected repayments or collateral meet or exceed the recorded investment in the loan. At September 30, 2011, substantially all of the total impaired loans were evaluated based on the fair value of the underlying collateral. When the Company records the fair value based upon a current appraisal, the fair value measurement is considered a Level 2 measurement. When a current appraisal is not available or there is estimated further impairment, the measurement is considered a Level 3 measurement.

Other Real Estate Owned (OREO): OREO is carried at the lower of carrying value or fair value on a non-recurring basis. Fair value is based upon independent appraisals or management s estimation of the collateral and is considered a Level 2 measurement. When a current appraisal is not available or there is estimated further impairment, the measurement is considered a Level 3 measurement.

Table of Contents

Note 3 Assets and Liabilities Measured at Fair Value - continued

Derivative Financial Instruments: Interest rate swaps and interest rate caps are carried at fair value and measured on a recurring basis. The measurement is based on valuation techniques including discounted cash flows analysis for each derivative. The analysis reflects the contractual remaining term of derivative, interest rates, volatility and expected cash payments. The measurement of the interest rate swap and cap are considered to be a Level 3 measurement.

The following tables reflect the changes in fair values for the nine and three-month periods ended September 30, 2011 and 2010 and where these changes are included in the income statement:

(Dollars in thousands)

	Nine months ended September 30,		Three months ended September 30,	
Description	**2011 Non-interest income: Fair value adjustment gain (loss)**	**2010 Non-interest income: Fair value adjustment gain (loss)**	**2011 Non-interest income: Fair value adjustment gain (loss)**	**2010 Non-interest income: Fair value adjustment gain (loss)**
Interest rate cap/swap	$ (185)	$ (644)	$ (60)	$ (201)
Total	$ (185)	$ (644)	$ (60)	$ (201)

The following table summarizes quantitative disclosures about the fair value for each category of assets carried at fair value as of September 30, 2011 and December 31, 2010 that are measured on a recurring basis. There were no liabilities carried at fair value as of September 30, 2011 or December 31, 2010 that are measured on a recurring basis.

(Dollars in thousands)

Description	**September 30, 2011**	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**
Available for sale securities				
Government sponsored enterprises	$ 2,289	$	$ 2,289	$
Mortgage backed securities	144,601		144,601	
Small Business Administration securities	38,059		38,059	
State and local government	20,585		20,006	579

Corporate and other securities	3,366	925	2,441	
	208,900	925	207,396	579
Interest rate cap/swap	(708)			(708)
Total	$ 208,192	$ 925	$ 207,396	$ (129)

11

Table of Contents

Note 3 Assets and Liabilities Measured at Fair Value continued

(Dollars in thousands)

Description	December 31, 2010	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Available for sale securities				
Government sponsored enterprises	$ 13,738	$	$ 13,738	$
Mortgage-backed securities	121,257		121,257	
Small Business Administration securities	31,496		31,496	
State and local government	19,055		18,430	625
Corporate and other securities	3,763	1,118	2,463	182
	189,309	1,118	187,384	807
Interest rate cap/swap	(778)			(778)
Total	$ 188,531	$ 1,118	$ 187,384	$ 29

The following tables reconcile the changes in Level 3 financial instruments for the nine and three months ended September 30, 2011, that are measured on a recurring basis.

(Dollars in thousands)	State and local government securities	Corporate and other securities	Interest rate Cap/Floor/Swap
Beginning Balance December 31, 2010	$ 625	$ 182	$ (778)
Total gains or losses (realized/unrealized)			
Included in earnings		(103)	(185)
Included in other comprehensive income		(79)	
Purchases, issuances, and settlements	(46)		255
Transfers in and/or out of Level 3			
Ending Balance September 30, 2011	$ 579	$	$ (708)

(Dollars in thousands)	State and local government securities	Corporate and other securities	Interest rate Cap/Floor/Swap
Beginning Balance June 30, 2011	$ 579	$ 99	$ (733)
Total gains or losses (realized/unrealized)			
Included in earnings		(99)	(60)
Included in other comprehensive income			
Purchases, issuances, and settlements			85
Transfers in and/or out of Level 3			
Ending Balance September 30, 2011	$ 579	$	$ (708)

12

Table of Contents

Note 3 Assets and Liabilities Measured at Fair Value continued

The following tables summarize quantitative disclosures about the fair value for each category of assets carried at fair value as of September 30, 2011 and December 31, 2010 that are measured on a non-recurring basis. Goodwill and other intangible assets are measured on a non-recurring basis at least annually. The valuation is performed at September 30 of each year. There were no liabilities carried at fair value as of September 30, 2011 or December 31, 2010 that are measured on a non-recurring basis.

(Dollars in thousands)

Description	September 30, 2011	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Impaired loans:				
Commercial & Industrial	$ 87	$	$ 87	$
Real estate:				
Mortgage-residential	459		459	
Mortgage-commercial	8,946		8,946	
Consumer:				
Home equity	7		7	
Other	20		20	
Total impaired	9,519		9,519	
Other real estate owned:				
Construction	2,207		2,207	
Mortgage-residential	1,498		1,498	
Mortgage-commercial	4,564		4,564	
Total other real estate owned	8,269		8,269	
Total	$ 17,788	$	$ 17,788	$

(Dollars in thousands)

Description	December 31, 2010	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Impaired loans:				
Commercial & Industrial	$ 96	$	$ 96	$
Real estate:				
Mortgage-residential	1,527		1,527	
Mortgage-commercial	7,914		7,914	
Consumer:				
Home equity	38		38	
Other	12		12	

Total impaired		9,587			9,587	
Other real estate owned:						
Construction		2,331			2,331	
Mortgage-residential		1,267			1,267	
Mortgage-commercial		3,306			3,306	
Total other real estate owned		6,904			6,904	
Total	$	16,491	$	$	16,491	$

Table of Contents

Note 4 Investment Securities

The amortized cost and estimated fair values of investment securities are summarized below:

AVAILABLE-FOR-SALE:

(Dollars in thousands)	**Amortized Cost**	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Fair Value**
September 30, 2011:				
Government sponsored enterprises	$ 2,284	$ 5	$	$ 2,289
Mortgage-backed securities	144,690	2,640	2,729	144,601
Small Business Administration pools	37,459	618	18	38,059
State and local government	19,511	1,074		20,585
Corporate and other securities	3,429	53	116	3,366
	$ 207,373	$ 4,390	$ 2,863	$ 208,900
December 31, 2010:				
Government sponsored enterprises	$ 13,793	$ 44	$ 99	$ 13,738
Mortgage-backed securities	124,113	1,558	4,414	121,257
Small Business Administration pools	31,451	135	90	31,496
State and local government	19,128	217	290	19,055
Corporate and other securities	4,311	244	792	3,763
	$ 192,796	$ 2,198	$ 5,685	$ 189,309

During the nine months ended September 30, 2011 and September 30, 2010, the Company received proceeds of $47.8 million and $56.5 million, respectively, from the sale of investment securities available-for-sale. Gross realized gains amounted to $2.3 million and gross realized losses amounted to $2.0 million for the nine months ended September 30, 2011. Gross realized gains amounted to $2.0 million and gross realized losses amounted to $1.7 million for the nine months ended September 30, 2010.

At September 30, 2011, corporate and other securities available-for-sale included the following at fair value: corporate bonds at $2.4 million, mutual funds at $898.6 thousand and Federal Home Loan Mortgage Corporation (the FHLMC or Freddie Mac) preferred stock of $26.2 thousand. At December 31 2010, corporate and other securities available-for-sale included the following at fair value: corporate bonds at $2.6 million, mutual funds at $883.1 thousand and FHLMC preferred stock of $234.6 thousand.

Table of Contents

Note 4 Investment Securities - continued

During the nine and three months ended September 30, 2011 and 2010, the Company recorded OTTI losses on available-for-sale securities as follows:

	Nine months ended September 30, 2011		Three months ended September 30, 2011	
(Dollars in thousands)	**Available-for-sale securities**	**Total**	**Available-for-sale securities**	**Total**
Total OTTI charge realized and unrealized	$ 262	$ 262	$ 191	$ 191
OTTI recognized in other comprehensive income (non-credit component)	208	208	141	141
Net impairment losses recognized in earnings (credit component)	$ 54	$ 54	$ 50	$ 50

	Nine months ended September 30, 2010		Three months ended September 30, 2010	
(Dollars in thousands)	**Available-for-sale securities**	**Total**	**Available-for-sale securities**	**Total**
Total OTTI charge realized and unrealized	$ 1,558	$ 1,558	$ 440	$ 440
OTTI recognized in other comprehensive income (non-credit component)	759	759		
Net impairment losses recognized in earnings (credit component)	$ 799	$ 799	$ 440	$ 440

Table of Contents

Note 4 Investment Securities continued

During 2011 and 2010, OTTIs occurred for which only a portion is attributed to credit loss and recognized in earnings. The remainder was reported in other comprehensive income. The following is an analysis of amounts relating to credit losses on debt securities recognized in earnings during the nine months ended September 30, 2011 and 2010.

(Dollars in thousands)	2011 Available for Sale	2010 Available for Sale	2010 Held to Maturity
Balance at beginning of period	$ 2,143	$ 165	$ 326
Other-than-temporary-impairment not previously recognized	50	146	98
Additional increase for which an other-than-temporary impairment was previously recognized related to credit losses	4	527	28
Other-than-temporary-impairment previously recognized on securities sold	(1,284)		
Realized losses during the period	(177)	(73)	
Transfer to available-for-sale		452	(452)
Balance related to credit losses on debt securities at end of period	$ 736	$ 1,217	$

For the nine months ended September 30, 2011, there was one trust preferred security and one non-agency mortgage backed security in which $54 thousand of OTTI representing the credit loss was recognized in earnings. For the three months ended September 30, 2011, there was $50 thousand of OTTI recognized in earnings for one non-agency mortgage backed security. During the third quarter of 2011, the trust preferred security was sold and an additional $455 thousand loss was recorded in earnings. The Company uses a third party to obtain information about the structure in order to determine how the underlying cash flows will be distributed to each security. For the trust preferred security, cash flows were evaluated assuming no prepayments with continued defaults of 150 basis-points annually and no subsequent recoveries of previous or ongoing defaults.

In evaluating the non-agency MBSs, relevant assumptions such as prepayment rate, default rate and loss severity on a loan level basis are used in determining the expected recovery of the contractual cash flows. The assumptions are that all loans greater than 60 days delinquent will be resolved across a two-year period at loss severities based on location and category. The weighted average loss severity for the loans greater than 60 days delinquent is 58.9%. The balance of the underlying portfolio cash flows are evaluated using ongoing assumptions for loss severities, prepayment rates and default rates. The ongoing assumptions for average prepayment rate, default rate and severity used in the valuations were approximately 5.7%, 3.0%, and 49.8%, respectively. The underlying collateral on substantially all of these securities is fixed rate residential first mortgages located throughout the United States. The underlying collateral includes various percentages of owner-occupied, as well as investment related single-family, 2-4 family and condominium residential properties. The securities were purchased at various discounts to par value. Based on the assumptions used in valuing the securities, the Company believes the existing discount and remaining subordinated collateral provide coverage against future credit losses on the downgraded securities for which no OTTI has been recognized.

Table of Contents

Note 4 Investment Securities continued

The following table shows gross unrealized losses and fair values, aggregated by investment category and length of time that individual securities have been in a continuous loss position at September 30, 2011and December 31, 2010.

(Dollars in thousands) September 30, 2011	Less than 12 months Fair Value	Less than 12 months Unrealized Loss	12 months or more Fair Value	12 months or more Unrealized Loss	Total Fair Value	Total Unrealized Loss
Available-for-sale securities:						
US Treasury and Government sponsored enterprises	$	$	$	$	$	$
Government Sponsored Enterprise mortgage-backed securities	27,771	257	3,011	38	30,782	295
Small Business Administration pools	7,079	18			7,079	18
Non-agency mortgage-backed securities	1,114	18	13,596	2,416	14,710	2,434
Corporate bonds and other	1,011	40	1,421	76	2,432	116
State and local government						
Total	$ 36,975	$ 333	$ 18,028	$ 2,530	$ 55,003	$ 2,863

(Dollars in thousands) December 31, 2010	Less than 12 months Fair Value	Less than 12 months Unrealized Loss	12 months or more Fair Value	12 months or more Unrealized Loss	Total Fair Value	Total Unrealized Loss
Available-for-sale securities:						
US Treasury and Government sponsored enterprises	$ 5,652	$ 99	$	$	$ 5,652	$ 99
Government Sponsored Enterprise mortgage-backed securities	32,416	402	780	1	33,196	403
Small Business Administration pools	5,355	90			5,355	90
Non-agency mortgage-backed securities	1,081	29	36,065	3,982	37,146	4,011
Corporate bonds and other	59	1	1,585	791	1,644	792
State and local government	8,909	290			8,909	290
Total	$ 53,472	$ 911	$ 38,430	$ 4,774	$ 91,902	$ 5,685

Government Sponsored Enterprise, Mortgage-Backed Securities: Beginning in 2008 and continuing through the first nine months of 2011, the bond markets and many institutional holders of bonds have come under a great deal of stress partially as a result of increasing delinquencies in the sub-prime mortgage lending market. At September 30, 2011, the Bank owns MBSs issued by government sponsored entities (GSEs) including collateralized mortgage obligations (CMOs) with a book value of $127.0 million and approximate fair value of $129.3 million. Current economic conditions have impacted MBSs issued by GSEs such as the FHLMC and the Federal National Mortgage Association (the FNMA or Fannie Mae). These entities have experienced increasing delinquencies in the underlying loans that make up the MBSs and CMOs. As of September 30, 2011 and December 31, 2010, all of the MBSs issued by GSEs are classified as Available for Sale . As of September 30, 2011 and December 31, 2010, unrealized losses amounted to $295 thousand and $403 thousand, respectively. The contractual cash flows of the investments are guaranteed by the GSE. Accordingly, it is expected that the securities would not be settled at a price less than the amortized cost of the Company s investment. Because the Company has the ability and intent to hold these investments until a recovery of fair value, which may be maturity, the Company does not consider the investments to be OTTI at September 30, 2011.

Table of Contents

Note 4 Investment Securities - continued

Non-agency mortgage backed securities: The Company also holds private label mortgage-backed securities (PLMBSs), including CMOs, at September 30, 2011 with an amortized cost of $17.7 million and approximate fair value of $15.3 million. Although these are not classified as sub-prime obligations or considered the high risk tranches, the majority of structured investments within all credit markets have been impacted by volatility and credit concerns and economic stresses beginning in 2008 and continuing through the first nine months of 2011. The result has been that the market for these investments is less liquid and the spread as compared to alternative investments has widened dramatically. During the second quarter of 2008, the Company implemented a leverage strategy whereby we acquired approximately $63.2 million in certain non-agency MBSs and CMOs. All of the mortgage assets acquired in this transaction were classified as prime or ALT-A securities and represented the senior or super-senior tranches of the securities. The assets acquired as part of this strategy were classified as held-to-maturity in the investment portfolio. Due to the significant spreads on these securities, they were all purchased at discounts. A detailed analysis of each of the CMO pools included in this leverage transaction, as well as privately held CMOs held previously in the available-for-sale portfolio, have been analyzed by reviewing underlying loan delinquencies, collateral value and resulting credit support. These securities have continued to experience increasing delinquencies in the underlying loans that make up the MBSs and CMOs. Management monitors each of these pools on a quarterly basis to identify any deterioration in the credit quality, collateral values and credit support underlying the investments.

For the three and nine months ended September 30, 2011, $50 thousand and $54 thousand in OTTI charges were recorded in earnings for the PLMBS portfolio, respectively. For the three and nine months ended September 30, 2010, $440 thousand and $799 thousand in OTTI charges were recorded in earnings, respectively. As prescribed by FASB ASC 320-10-65, the Company has recognized impairment charges in earnings for the amounts related to credit losses and amounts related to non-credit losses have been recognized in other comprehensive income. The credit losses were estimated by projecting the expected cash flows estimating prepayment speeds, increasing defaults and collateral loss severities. The credit loss portion of the impairment charge represents the difference between the present value of the expected cash flows and the amortized cost basis of the securities.

The following table summarizes as of September 30, 2011 the number of CUSIPs, par value, carrying value and fair value of the non-agency mortgage-backed/CMOs securities by credit rating. The credit rating reflects the lowest credit rating by any major rating agency.

(Dollars in thousands)

Credit Rating	Number of CUSIPs	Par Value	Amortized Cost	Fair Value
AAA	8	$ 2,359	$ 2,359	$ 2,227
AA	1	384	384	384
Aa2	1	90	90	89
Aa3	1	500	500	485
A	1	362	362	361
Below Investment Grade	11	16,195	13,998	11,726
Total	23	$ 19,890	$ 17,693	$ 15,272

During the nine months ended September 30, 2011, the Company sold 14 non-agency MBSs with a total book value of approximately $29.8 million. Ten of these securities in the total amount of $21.3 million were rated below investment grade by the rating agencies with the other four being rated above investment grade. Four of these securities with a book value of approximately $3.8 million, with $3.6 million below investment grade, were sold in the second quarter of 2011, and seven securities with a book value of approximately $26.0 million, with $17.7 million rated below investment grade, were sold in the first quarter of 2011. The sales of these non-agency MBSs have served to significantly reduce the level of securities on the Company s balance sheet that are rated below investment grade.

Table of Contents

Note 4 Investment Securities continued

Corporate Bonds: During the nine months ended September 30, 2011 and 2010, the Company recorded $4.0 thousand and $1.1 million in OTTI charges on a preferred term security, respectively. During the third quarter of 2011, the Company sold this security and recorded an additional realized loss of $455 thousand. This loss was offset by the sale of two municipal bonds with a recorded gain of $488 thousand. The Company s unrealized loss on investments in corporate bonds relates to bonds with three different issuers. The economic conditions beginning in 2008 and continuing into the first nine months of 2011 have had a significant impact on all corporate debt obligations. As a result, the spreads on all of the securities have widened dramatically and the liquidity of many of these investments has been negatively impacted. One of these bonds is rated Aa2 by Moody (investment grade) and another bond is rated A2 by Moody (investment grade). The third bond is below investment grade and rated Ba1 by Moody and BBB- by Fitch with a carrying value of $998 thousand and a fair value of $946 thousand and matures in July 2014. All of the corporate bonds held by the Company are reviewed on a quarterly basis to identify downgrades by rating agencies as well as deterioration of the underlying collateral or the issuer s ability to service the debt obligation. The Company does not consider these investments to be OTTI at September 30, 2011.

Small Business Administration Pools: These pools are guaranteed pass-thru with the full faith and credit of the United States government. Because the Company has the ability and intent to hold these investments until a recovery of fair value, which may be maturity, the Company does not consider the investments to be OTTI at September 30, 2011.

State and Local Governments and Other: Unrealized losses on these investments are attributable to increases in interest rates, rather than credit quality. As of September 30, 2011, there were no investments in this category with unrealized losses.

The amortized cost and fair value of investment securities at September 30, 2011, by contractual maturity, are as follows. Expected maturities differ from contractual maturities because borrowers may have the right to call or prepay the obligations with or without prepayment penalties. MBSs are based on average life at estimated prepayment speeds.

	Available-for-sale	
(Dollars in thousands)	**Amortized Cost**	**Fair Value**
Due in one year or less	$ 5,432	$ 4,958
Due after one year through five years	101,111	101,462
Due after five years through ten years	81,894	82,536
Due after ten years	18,936	19,944
	$ 207,373	$ 208,900

Note 5 Loans

Loans summarized by category as of September 30, 2011 and December 31, 2010 are as follows:

(Dollars in thousands)	September 30, 2011	December 31, 2010
Commercial, financial and agricultural	$ 20,077	$ 20,555
Real estate:		
Construction	9,045	10,540
Mortgage-residential	40,146	46,684
Mortgage-commercial	221,365	218,298
Consumer:		
Home equity	27,958	27,747
Other	5,642	6,130
Total	$ 324,233	$ 329,954

Table of Contents

Note 5 Loans-continued

At September 30, 2011, there were $5.2 million of residential mortgage loans held for sale at fair value. These loans are originated with firm purchase commitments from various investors at the time the loans are closed. Generally, funds are received and the loans are transferred to the investors within three to seven business days.

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

	Nine months ended	
(Dollars in thousands)	**September 30, 2011**	**September 30, 2010**
Balance at the beginning of period	$ 4,911	$ 4,854
Provision for loan losses	1,110	1,365
Charged off loans	(1,368)	(1,481)
Recoveries	55	103
Balance at end of period	$ 4,708	$ 4,841

	Three months ended	
(Dollars in thousands)	**September 30, 2011**	**September 30, 2010**
Balance at the beginning of period	$ 4,716	$ 4,838
Provision for loan losses	360	235
Charged off loans	(388)	(282)
Recoveries	20	50
Balance at end of period	$ 4,708	$ 4,841

Table of Contents

Note 5 Loans-continued

The detailed activity in the allowance for loan losses and the recorded investment in loans receivable as of and for the three months ended September 30, 2011 and the year ended December 31, 2010 is as follows:

(Dollars in thousands)	**Commercial**	**Real estate Construction**	**Real estate Mortgage Residential**	**Real estate Mortgage Commercial**	**Consumer Home equity**	**Consumer Other**	**Unallocated**	**Total**
2011								
Allowance for loan losses:								
Beginning balance December 31, 2010	$ 681	$ 905	$ 465	$ 1,404	$ 325	$ 88	$ 1,043	$ 4,911
Charge-offs	239		142	683	247	57		1,368
Recoveries	27		4		4	20		55
Provisions	(153)	(521)	127	862	409	(3)	389	1,110
Ending balance September 30, 2011	$ 316	$ 384	$ 454	$ 1,583	$ 491	$ 48	$ 1,432	$ 4,708
Ending balances:								
Individually evaluated for impairment	$	$	$	$	$	$	$	$
Collectively evaluated for impairment	316	384	454	1,583	491	48	1,432	4,708
Loans receivable:								
Ending balance-total	$ 20,077	9,045	$ 40,146	$ 221,365	$ 27,958	$ 5,642		$ 324,233
Ending balances:								
Individually evaluated for impairment	87		459	8,946	7	20		9,519
Collectively evaluated for impairment	$ 19,990	$ 9,045	$ 39,687	$ 212,419	$ 27,951	$ 5,622	$	$ 314,714

Table of Contents

Note 5 Loans-continued

(Dollars in thousands)	Commercial	Real estate Construction	Real estate Mortgage Residential	Real estate Mortgage Commercial	Consumer Home equity	Consumer Other	Unallocated	Total
2010								
Allowance for loan losses:								
Beginning balance December 31, 2009	$ 634	$ 1,331	$ 138	$ 1,522	$ 105	$ 127	$ 997	$ 4,854
Charge-offs	125		512	984	186	141		1,948
Recoveries	31		7	38	9	42		127
Provisions	141	(426)	832	828	397	60	46	1,878
Ending balance December 31, 2010	$ 681	$ 905	$ 465	$ 1,404	$ 325	$ 88	$ 1043	$ 4,911
Ending balances:								
Individually evaluated for impairment	$	$	$	$ 96	$	$	$	$ 96
Collectively evaluated for impairment	681	905	465	1,308	325	88	1,043	4,815
Loans receivable:								
Ending balance-total	$ 20,555	$ 10,540	$ 46,684	$ 218,298	$ 27,747	$ 6,130	$	$ 329,954
Ending balances:								
Individually evaluated for impairment	96		1,527	7,914	38	12		9,587
Collectively evaluated for impairment	$ 20,459	$ 10,540	$ 45,157	$ 210,384	$ 27,709	$ 6,118	$	$ 320,367

Loans outstanding to bank directors, executive officers and their related business interests amounted to $10.4 million and $10.9 million at September 30, 2011 and September 30, 2010, respectively. Repayments on these loans during the nine months ended September 30, 2011 were $1.3 million and loans made amounted to $808 thousand. Repayments on these loans during the nine months ended September 30, 2010 were $1.7 million and loans made amounted to $5.6 million. Related party loans are made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with unrelated persons and generally do not involve more than the normal risk of collectability.

Table of Contents

Note 5 Loans-continued

The following table presents at September 30, 2011 and December 31, 2010 loans individually evaluated and considered impaired under FAS ASC 310 Accounting by Creditors for Impairment of a Loan. Impairment includes performing troubled debt restructurings.

(Dollars in thousands)	**September 30, 2011**	**December 31, 2010**
Total loans considered impaired	$ 9,519	$ 9,587
Loans considered impaired for which there is a related allowance for loan loss:		
Outstanding loan balance		378
Related allowance		96
Loans considered impaired and previously written down to fair value	9,519	9,209
Average impaired loans	9,894	10,576

The following tables, by loan category, present at September 30, 2011 and December 31, 2010 loans individually evaluated and considered impaired under FAS ASC 310 Accounting by Creditors for Impairment of a Loan. Impairment includes performing troubled debt restructurings.

(Dollars in thousands) September 30, 2011	**Recorded Investment**	**Unpaid Principal Balance**	**Related Allowance**	**Average Recorded Investment**	**Interest Income Recognized**
With no allowance recorded:					
Commercial	$ 87	$ 94	$	$ 96	$ 2
Real estate:					
Construction					
Mortgage-residential	459	474		479	3
Mortgage-commercial	8,946	9,196		9,279	297
Consumer:					
Home Equity	7	7		10	
Other	20	20		30	1
With an allowance recorded:					
Commercial					
Real estate:					
Construction					
Mortgage-residential					
Mortgage-commercial					
Consumer:					
Home Equity					
Other					
Total:					
Commercial	$ 87	$ 94	$	$ 96	$ 2
Real estate:					
Construction					
Mortgage-residential	459	474		479	3
Mortgage-commercial	8,946	9,196		9,279	297

Consumer:					
Home Equity	7	7		10	
Other	20	20		30	1
	$ 9,519	$ 9,791	$	$ 9,894	$ 303

The Company determined that all specific reserves for impaired loans were confirmed losses and were charged-off against outstanding loan balances during the nine months ended September 30, 2011.

Table of Contents

Note 5 Loans-continued

(Dollars in thousands) December 31, 2010	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no allowance recorded:					
Commercial	$ 96	$ 96	$	$ 108	$ 4
Real estate:					
Construction					
Mortgage-residential	1,527	1,835		1,853	20
Mortgage-commercial	7,536	8,077		8,180	272
Consumer:					
Home Equity	38	38		40	
Other	12	12		14	
With an allowance recorded:					
Commercial					
Real estate:					
Construction					
Mortgage-residential					
Mortgage-commercial	378	378	96	381	27
Consumer:					
Home Equity					
Other					
Total:					
Commercial	96	96		108	4
Real estate:					
Construction					
Mortgage-residential	1,527	1,835		1,853	20
Mortgage-commercial	7,914	8,455	96	8,561	299
Consumer:					
Home Equity	38	38		40	
Other	12	12		14	
	$ 9,587	$ 10,436	$ 96	$ 10,576	$ 323

The Company categorizes loans into risk categories based on relevant information about the ability of borrowers to service their debt, including: current financial information, historical payment experience, credit documentation, public information, and current economic trends, among other factors. The Company analyzes loans individually by classifying the loans as to credit risk. This analysis is performed on a monthly basis. The Company uses the following definitions for risk ratings:

Special Mention. Loans classified as special mention have a potential weakness that deserves 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. Special mention assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification.

Substandard. Loans classified as substandard are inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

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

Table of Contents

Note 5 Loans-continued

Loans not meeting the criteria above that are analyzed individually as part of the above described process are considered to be pass rated loans. As of September 30, 2011 and December 31, 2010, and based on the most recent analysis performed, the risk category of loans by class of loans is shown in the table below. As of September 30, 2011 and December 31, 2010, no loans were classified as doubtful.

(Dollars in thousands) **September 30, 2011**	**Pass**	**Special** **Mention**	**Substandard**	**Doubtful**	**Total**
Commercial, financial & agricultural	$ 19,177	$ 551	$ 349	$	$ 20,077
Real estate:					
Construction	3,961		5,084		9,045
Mortgage residential	39,123	213	810		40,146
Mortgage commercial	199,554	10,426	11,385		221,365
Consumer:					
Home Equity	27,649	40	269		27,958
Other	5,572	48	22		5,642
Total	$ 295,036	$ 11,278	$ 17,919	$	$ 324,233

(Dollars in thousands) **December 31, 2010**	**Special** **Pass**	**Mention**	**Substandard**	**Doubtful**	**Total**
Commercial, financial & agricultural	$ 19,722	$ 232	$ 602	$	$ 20,556
Real estate:					
Construction	5,111		5,429		10,540
Mortgage residential	44,815		1,869		46,684
Mortgage commercial	196,153	8,270	13,874		218,297
Consumer:					
Home Equity	27,501	100	146		27,747
Other	6,124	6			6,130
Total	$ 299,426	$ 8,608	$ 21,920	$	$ 329,954

A delinquent loan is generally placed in nonaccrual status when it becomes 90 days or more past due. At the time a loan is placed in nonaccrual status, all interest, which has been accrued on the loan but remains unpaid is reversed and deducted from earnings as a reduction of reported interest income. No additional interest is accrued on the loan balance until the collection of both principal and interest becomes reasonably certain. At September 30, 2011 and December 31, 2010, nonaccrual loans totaled $3.4 million and $5.9 million, respectively.

Troubled debt restructurings (TDRs) are loans which have been restructured from their original contractual terms and include concessions that would not otherwise have been granted outside of the financial difficulty of the borrower. Concessions can relate to the contractual interest rate, maturity date, or payment structure of the note. As part of our workout plan for individual loan relationships, we may restructure loan terms to assist borrowers facing challenges in the current economic environment. The purpose of a TDR is to facilitate ultimate repayment of the loan. TDRs included in impaired loans at September 30, 2011 and December 31, 2010 amounted to $7.9 million and $4.4 million, respectively.

Our policy with respect to accrual of interest on loans restructured in a TDR follows relevant supervisory guidance. That is, if a borrower has demonstrated performance under the previous loan terms and shows capacity to perform under the restructured loan terms; continued accrual of interest at the restructured interest rate is likely. If a borrower was materially delinquent on payments prior to the restructuring but shows capacity to meet the restructured loan terms, the loan will likely continue as nonaccrual going forward. Lastly, if the borrower does not perform under the restructured terms, the loan is placed on nonaccrual status. TDRs in nonaccrual status at September 30, 2011 and December 31, 2010 amounted to $1.8 million and $696 thousand, respectively.

Table of Contents

Note 5 Loans-continued

We will continue to closely monitor these loans and will cease accruing interest on them if management believes that the borrowers may not continue performing based on the restructured note terms. If, after previously being classified as a TDR, a loan is restructured a second time, then that loan is automatically placed on nonaccrual status. Our policy with respect to nonperforming loans requires the borrower to make a minimum of six consecutive payments in accordance with the loan terms before that loan can be placed back on accrual status. Further, the borrower must show capacity to continue performing into the future prior to restoration of accrual status. To date, we have not restored any nonaccrual loan classified as a TDR to accrual status. We believe that all of our modified loans meet the definition of a TDR.

There were no loans greater than ninety days delinquent and still accruing interest at September 30, 2011. Loans greater than ninety days delinquent and still accruing interest at December 31, 2010 amounted to $373 thousand.

The following tables, by loan category, present loans past due and in non-accrual status as of September 30, 2011 and December 31, 2010:

(Dollars in thousands) September 30, 2011	**30-59 Days Past Due**	**60-89 Days Past Due**	**Greater than 90 Days and Accruing**	**Nonaccrual**	**Total Past Due**	**Current**	**Total Loans**
Commercial	$ 128	$ 267	$	$ 52	$ 447	$ 19,630	$ 20,077
Real estate:							
Construction						9,045	9,045
Mortgage-residential	67	315		459	841	39,305	40,146
Mortgage-commercial	1,500	492		2,870	4,862	216,503	221,365
Consumer:							
Home equity	265	31		7	303	27,655	27,958
Other	29	2		20	51	5,591	5,642
Total	$ 1,989	$ 1,107	$	$ 3,408	$ 6,504	$ 317,729	$ 324,233

(Dollars in thousands) December 31, 2010	**30-59 Days Past Due**	**60-89 Days Past Due**	**Greater than 90 Days and Accruing**	**Nonaccrual**	**Total Past Due**	**Current**	**Total Loans**
Commercial	$ 201	$ 10	$	$ 55	$ 266	$ 20,288	$ 20,554
Real estate:							
Construction						10,540	10,540
Mortgage-residential	264	17		1,527	1,808	44,877	46,685
Mortgage-commercial	351	1,168	373	4,258	6,150	212,147	218,297
Consumer:							
Home equity	252	106		38	396	27,352	27,748
Other	24	15		12	51	6,079	6,130
Total	$ 1,092	$ 1,316	$ 373	$ 5,890	$ 8,671	$ 321,283	$ 329,954

Table of Contents

Note 5 Loans-continued

As a result of adopting the amendments in ASU 2011-02, the Bank reassessed all restructurings that occurred on or after the beginning of the fiscal year of adoption (January 1, 2011) to determine whether they are considered TDRs under the amended guidance. The Bank identified as TDRs certain loans for which the allowance for loan losses had previously been measured under a general allowance methodology. Upon identifying those loans as TDRs, the Bank identified them as impaired under the guidance in ASC 310-10-35. The amendments in ASU 2011-02 require prospective application of the impairment measurement guidance in ASC 310-10-35 for those loans newly identified as impaired. At the end of the first interim period of adoption (September 30, 2011), the recorded investment in loans for which the allowance was previously measured under a general allowance methodology and are now impaired under ASC 310-10-35 was $7.9 million, and there was no allowance for loan losses associated with those loans.

The following tables, by loan category, present loans determined to be TDRs during the three and nine month periods ended September 30, 2011.

	For the three months ended September 30, 2011				
Troubled Debt Restructurings (Dollars in thousands)	**Number of Contracts**		**Pre-Modification Outstanding Recorded Investment**		**Post-Modification Outstanding Recorded Investment**
Nonaccrual					
Mortgage-Commercial	1	$	648	$	648
Total nonaccrual	1	$	648	$	648
Accrual					
Mortgage-Commercial	1	$	337	$	315
Total Accrual	1	$	337	$	315
Total TDRs	2	$	985	$	963

	For the nine months ended September 30, 2011				
Troubled Debt Restructurings (Dollars in thousands)	**Number of Contracts**		**Pre-Modification Outstanding Recorded Investment**		**Post-Modification Outstanding Recorded Investment**
Nonaccrual					
Mortgage-Commercial	5	$	765	$	765
Commercial & Industrial	2		53		53
Total nonaccrual	7	$	818	$	818
Accrual					
Mortgage-Commercial	1	$	337	$	315
Total Accrual	1	$	337	$	315
Total TDRs	8	$	1,155	$	1,133

During the nine months ended September 30, 2011, the Bank modified eight loans that were considered to be TDRs. The payment and interest rate were lowered for six of these loans, the payment was lowered for one loan and for one loan the company and guarantor were released.

Table of Contents

Note 5 Loans-continued

The following tables, by loan category, present loans determined to be TDRs in the last twelve months that had payment defaults during the three or nine month periods ended September 30, 2011

Troubled Debt Restructurings that subsequently defaulted this period (Dollars in thousands)	**For the three months ended September 30, 2011**		
	Number of Contracts		**Recorded Investment**
Mortgage-Commercial	3	$	61
Commercial & Industrial	1		14
Total TDRs	4	$	75

Troubled Debt Restructurings that subsequently defaulted this period (Dollars in thousands)	**For the nine months ended September 30, 2011**		
	Number of Contracts		**Recorded Investment**
Mortgage-Commercial	3	$	61
Commercial & Industrial	1		14
Total TDRs	4	$	75

During the three and nine months ended September 30, 2011, four nonaccrual loans that had previously been restructured, had payment defaults.

In the determination of the allowance for loan losses, all TDRs are reviewed to ensure that one of the three proper valuation methods (fair market value of the collateral, present value of cash flows, or observable market price) is adhered to. All non-accrual loans are written down to its corresponding collateral value. All TDR accruing loans and where the loan balance exceeds the present value of cash flow will have a specific allocation. All nonaccrual loans are considered impaired. Under ASC 310-10, a loan is impaired when it is probable that the bank will be unable to collect all amounts due including both principal and interest according to the contractual terms of the loan agreement.

Note 6 - Recently Issued Accounting Pronouncements

In July 2010, the Receivables topic of the Accounting Standards Codification (ASC) was amended by Accounting Standards Update (ASU) 2010-20 to require expanded disclosures related to a company s allowance for credit losses and the credit quality of its financing receivables. The amendments require the allowance disclosures to be provided on a disaggregated basis. The Company is required to include these disclosures in its interim and annual financial statements. See Note 5-Loans.

Disclosures about TDRs required by ASU 2010-20 were deferred by the Financial Accounting Standards Board (FASB) in ASU 2011-01 issued in January 2011. In April 2011 the FASB issued ASU 2011-02 to assist creditors with their determination of when a restructuring is a TDR. The determination is based on whether the restructuring constitutes a concession and whether the debtor is experiencing financial difficulties as both events must be present.

Disclosures related to TDRs under ASU 2010-20 have been presented in Note 5-Loans.

Table of Contents

Note 6 - Recently Issued Accounting Pronouncements-continued

In December 2010, the Intangibles topic of the ASC was amended to modify Step 1 of the goodwill impairment test for reporting units with zero or negative carrying amounts. For those reporting units, an entity is required to perform Step 2 of the goodwill impairment test if it is more likely than not that a goodwill impairment exists. Any resulting goodwill impairment should be recorded as a cumulative-effect adjustment to beginning retained earnings upon adoption. Impairments occurring subsequent to adoption should be included in earnings. The amendment was effective for the Company on January 1, 2011.

In September 2011, the Intangibles topic was again amended to permit an entity to consider qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the two-step goodwill impairment test. These amendments will be effective for the Company on January 1, 2012.

In December 2010, the Business Combinations topic of the ASC was amended to specify that if a public entity presents comparative financial statements, the entity should disclose revenue and earnings of the combined entity as though the business combination that occurred during the current year had occurred as of the beginning of the comparable prior annual reporting period only. The amendment also requires that the supplemental pro forma disclosures include a description of the nature and amount of any material, nonrecurring pro forma adjustments directly attributable to the business combination included in the reported pro forma revenue and earnings. This amendment is effective for the Company for business combinations for which the acquisition date is on or after January 1, 2011. The Company does not expect the amendment to have any impact on the financial statements.

In April 2011, the criteria used to determine effective control of transferred assets in the Transfers and Servicing topic of the ASC was amended by ASU 2011-03. The requirement for the transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed terms and the collateral maintenance implementation guidance related to that criterion were removed from the assessment of effective control. The other criteria to assess effective control were not changed. The amendments are effective for the Company beginning January 1, 2012 but are not expected to have a material effect on the financial statements.

ASU 2011-04 was issued in May 2011 to amend the Fair Value Measurement topic of the ASC by clarifying the application of existing fair value measurement and disclosure requirements and by changing particular principles or requirements for measuring fair value or for disclosing information about fair value measurements. The amendments will be effective for the Company beginning January 1, 2012 but are not expected to have a material effect on the financial statements.

The Comprehensive Income topic of the ASC was amended in June 2011. The amendment eliminates the option to present other comprehensive income as a part of the statement of changes in shareholders equity. The amendment requires consecutive presentation of the statement of net income and other comprehensive income and requires an entity to present reclassification adjustments from other comprehensive income to net income on the face of the financial statements. The amendments will be applicable to the Company on January 1, 2012 and will be applied retrospectively.

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

Note 7 Fair Value of Financial Instruments

FASB ASC 825-10-50 Disclosure about Fair Value of Financial Instruments , requires the Company to disclose estimated fair values for its financial instruments. Fair value estimates, methods, and assumptions are set forth below.

Cash and short term investments - The carrying amount of these financial instruments (cash and due from banks, federal funds sold and securities purchased under agreements to resell) approximates fair value. All mature within 90 days and do not present unanticipated credit concerns.

Investment Securities - Fair values are based on quoted market prices, where available. If quoted market prices are not available, fair values are based on quoted market prices of comparable instruments.

Table of Contents

Note 7 Fair Value of Financial Instruments-continued

Loans held for sale The fair value approximates the carrying value as the Company has firm purchase commitments to sell these loans at carrying value.

Loans - The fair value of loans are estimated by discounting the future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities. As discount rates are based on current loan rates as well as management estimates, the fair values presented may not be indicative of the value negotiated in an actual sale.

Accrued Interest Receivable - The fair value approximates the carrying value.

Interest rate cap/swap - The fair value approximates the carrying value.

Deposits - The fair value of demand deposits, savings accounts, and money market accounts is the amount payable on demand at the reporting date. The fair value of fixed-maturity certificates of deposits is estimated by discounting the future cash flows using rates currently offered for deposits of similar remaining maturities.

Federal Home Loan Bank Advances - Fair value is estimated based on discounted cash flows using current market rates for borrowings with similar terms.

Short Term Borrowings - The carrying value of short term borrowings (securities sold under agreements to repurchase and demand notes to the U.S. Treasury) approximates fair value.

Junior Subordinated Debentures - The fair values of junior subordinated debentures is estimated by using discounted cash flow analyses based on incremental borrowing rates for similar types of instruments.

Accrued Interest Payable - The fair value approximates the carrying value.

Commitments to Extend Credit - The fair value of these commitments is immaterial because their underlying interest rates approximate market.

The carrying amount and estimated fair value of the Company s financial instruments are as follows:

	September 30, 2011		December 31, 2010	
(Dollars in thousands)	**Carrying Amount**	**Fair Value**	**Carrying Amount**	**Fair Value**
Financial Assets:				
Cash and short term investments	$ 17,987	$ 17,987	$ 26,461	$ 26,461
Available-for-sale securities	208,899	208,899	189,309	189,309
Other investments, at cost	5,984	5,984	6,841	6,841
Loans held for sale	5,195	5,195		
Loans receivable	324,233	329,036	329,954	326,805
Allowance for loan losses	4,708		4,911	
Net loans	319,525	329,036	325,043	326,805
Accrued interest	1,959	1,959	2,113	2,113
Interest rate cap/floor/swap	(708)	(708)	(778)	(778)
Financial liabilities:				
Non-interest bearing demand	$ 84,857	$ 84,857	$ 72,625	$ 72,625
NOW and money market accounts	139,462	139,462	123,604	123,604
Savings	32,670	32,670	29,886	29,886
Time deposits	216,171	219,297	229,229	232,444
Total deposits	473,160	476,286	455,344	458,559
Federal Home Loan Bank Advances	48,724	55,429	68,094	73,619
Short term borrowings	17,027	17,027	12,806	12,806
Junior subordinated debentures	15,464	15,464	15,464	15,464
Accrued interest payable	1,741	1,741	2,121	2,121

Table of Contents

Note 8 Subsequent Events

Subsequent events are events or transactions that occur after the balance sheet date but before financial statements are issued. Recognized subsequent events are events or transactions that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements. Nonrecognized subsequent events are events that provide evidence about conditions that did not exist at the date of the balance sheet but arose after that date. Management has reviewed events occurring through the date the financial statements were available to be issued and no subsequent events occurred requiring accrual or disclosure.

Table of Contents

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

This report contains statements which constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. Forward-looking statements may relate to, among other matters, the financial condition, results of operations, plans, objectives, future performance, and business of our Company. Forward-looking statements are based on many assumptions and estimates and are not guarantees of future performance. Our actual results may differ materially from those anticipated in any forward-looking statements, as they will depend on many factors about which we are unsure, including many factors which are beyond our control. The words may, would, could, should, will, expect, anticipate, predict, project, potential, continue, assume, be forecast, goal, and estimate, as well as similar expressions, are meant to identify such forward-looking statements. Potential risks and uncertainties that could cause our actual results to differ materially from those anticipated in our forward-looking statements include, without limitation, those described under the heading Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2010 as filed with the Securities and Exchange Commission (the SEC) and the following:

- changes in political conditions and the legislative or regulatory environment, including the effect of the recent financial reform legislation on the banking and financial services industries,
- our ability to comply with the terms of the formal written agreement between the Bank and the Office of the Comptroller of the Currency (the OCC) within the timeframes specified;
- changes in the interest rate environment which could reduce anticipated or actual margins;
- increases in competitive pressure in the banking and financial services industries;
- reduced earnings due to higher credit losses generally and specifically potentially because losses in our real estate loan portfolio may be greater than expected due to economic factors, including declining real estate values, increasing interest rates, increasing unemployment, or changes in payment behavior or other factors;
- high concentrations of real estate-based loans collateralized by real estate in a weak commercial real estate market;
- general economic conditions, either nationally or regionally and especially in our primary service area, being less favorable than expected resulting in, among other things, a deterioration in credit quality;
- increased funding costs due to market illiquidity, increased competition for funding, or increased regulatory requirements with regard to funding,
- changes occurring in business conditions and inflation;
- changes in technology;
- the adequacy of our level of allowance for loan loss;
- the rate of delinquencies and amounts of loans charged-off;
- the rates of loan growth;
- adverse changes in asset quality and resulting credit risk-related losses and expenses;

- changes in monetary and tax policies;
- loss of consumer confidence and economic disruptions resulting from terrorist activities or other military actions;
- changes in the securities markets; and
- other risks and uncertainties detailed from time to time in our filings with the SEC.

These risks are exacerbated by the developments over the last three years in local, national and international financial markets, and we are unable to predict what effect these uncertain market conditions will continue to have on our Company. Beginning in 2008 and continuing through the third quarter of 2011, the capital and credit markets experienced unprecedented levels of extended volatility and disruption. During the first half of 2011, there was a general expectation within the economic and business community that conditions, while slow by historical standards, were stabilizing and were expected to show continued improvement. However, as a result of U.S. government fiscal challenges and resulting downgrade of the U.S. government debt by Standard & Poor s, continued volatility in European sovereign and bank debt, little to no improvement in domestic employment conditions, and the economic and monetary policy statements by the Board of Governors of the Federal Reserve System (the Federal Reserve) during the third quarter of 2011, an increasing number of economists began predicting more negative economic forecasts and the possibility of a double-dip recession. There can be no assurance that these unprecedented negative developments will not continue to materially and adversely affect the U.S. economy in general, the banking industry, and our business, financial condition and results of operations.

All forward-looking statements in this report are based on information available to us as of the date of this report. Although we believe that the expectations reflected in our forward-looking statements are reasonable, we cannot guarantee you that these expectations will be achieved. We undertake no obligation to publicly update or otherwise revise any forward-looking statements, whether as a result of new information, future events, or otherwise.

Table of Contents

Overview

The following discussion describes our results of operations for the nine months and three months ended September 30, 2011 as compared to the nine month and three month period ended September 30, 2010 and also analyzes our financial condition as of September 30, 2011 as compared to December 31, 2010. Like most community banks, we derive most of our income from interest we receive on our loans and investments. Our primary source of funds for making these loans and investments is our deposits, on which we pay interest. Consequently, one of the key measures of our success is our amount of net interest income, or the difference between the income on our interest-earning assets, such as loans and investments, and the expense on our interest-bearing liabilities, such as deposits. Another key measure is the spread between the yield we earn on these interest-earning assets and the rate we pay on our interest-bearing liabilities.

There are risks inherent in all loans, so we maintain an allowance for loan losses to absorb probable losses on existing loans that may become uncollectible. We establish and maintain this allowance by charging a provision for loan losses against our operating earnings. In the following section we have included a discussion of this process, as well as several tables describing our allowance for loan losses and the allocation of this allowance among our various categories of loans.

In addition to earning interest on our loans and investments, we earn income through fees and other expenses we charge to our customers. We describe the various components of this non-interest income, as well as our non-interest expense, in the following discussion.

The following discussion and analysis also identifies significant factors that have affected our financial position and operating results during the periods included in the accompanying financial statements. We encourage you to read this discussion and analysis in conjunction with the financial statements and the related notes and the other statistical information also included in this report.

Critical Accounting Policies

We have adopted various accounting policies that govern the application of accounting principles generally accepted in the United States and with general practices within the banking industry in the preparation of our financial statements. Our significant accounting policies are described in the footnotes to our unaudited consolidated financial statements as of September 30, 2011 and our notes included in the audited consolidated financial statements in our 2010 Annual Report on Form 10-K as filed with the SEC.

Certain accounting policies involve significant judgments and assumptions by us that have a material impact on the carrying value of certain assets and liabilities. We consider these accounting policies to be critical accounting policies. The judgment and assumptions we use are based on historical experience and other factors, which we believe to be reasonable under the circumstances. Because of the nature of the judgment and assumptions we make, actual results could differ from these judgments and estimates that could have a material impact on the carrying values of our assets and liabilities and our results of operations.

We believe the allowance for loan losses is the critical accounting policy that requires the most significant judgment and estimates used in preparation of our consolidated financial statements. Some of the more critical judgments supporting the amount of our allowance for loan losses include judgments about the credit worthiness of borrowers, the estimated value of the underlying collateral, the assumptions about cash flow, determination of loss factors for estimating credit losses, the impact of current events, and conditions, and other factors impacting the level of probable inherent losses. Under different conditions or using different assumptions, the actual amount of credit losses incurred by us may be different from management s estimates provided in our consolidated financial statements. Refer to the portion of this discussion that addresses our allowance for loan losses for a more complete discussion of our processes and methodology for determining our allowance for loan losses.

The evaluation and recognition of OTTI on certain investments, including our private label MBSs and other corporate debt security holdings, requires significant judgment and estimates. Some of the more critical judgments supporting the evaluation of OTTI include projected cash flows including prepayment assumptions, default rates and severities of losses on the underlying collateral within the security. Under different conditions or utilizing different assumptions, the actual OTTI recognized by us may be different from the actual amounts recognized in our consolidated financial statements. See Note 4 to the financial statements for the disclosure of certain of the assumptions used as well as OTTI recognized in the financial statements during the nine and three months ended September 30, 2011 and 2010.

Table of Contents

Recent Developments

Regulatory Developments

Formal Agreement. On April 6, 2010, the Bank entered into a formal written agreement (the Formal Agreement) with its primary federal regulator, the OCC. The Formal Agreement is based on the findings of the OCC during a 2009 on-site examination of the Bank. As reflected in the Formal Agreement, the OCC s primary concern with the Bank is driven by the rating agencies downgrades of non-agency MBSs in its investment portfolio. These securities, purchased in 2004 through 2008, were all rated AAA by the rating agencies at the time of purchase; however, they have been impacted by the economic recession and the stress on the residential housing sector. These ratings do not reflect the discounted purchase price paid by the Bank. They only reflect their analysis of the performance of the security overall, and therefore, a downgrade does not capture the risk of loss to the Bank. The Formal Agreement did not require any adjustment to the Bank s balance sheet or income statement; nor did it change the Bank s well capitalized status. The OCC has, however, separately established the following individual minimum capital ratios for the Bank: a Tier 1 leverage capital ratio of at least 8.00%, a Tier 1 risk-based capital ratio of at least 10.00%, and a Total risk-based capital ratio of at least 12.00%. As of December 31, 2010 and September 30, 2011, the Bank exceeds each of these ratios and remains well capitalized.

The Board of Directors has appointed an independent compliance committee made up of directors to monitor and report on compliance with the terms of the Formal Agreement. The Bank intends to take all actions necessary to enable it to comply with the requirements of the Formal Agreement, and as of the date hereof management has submitted all documentation required to the OCC. There can be no assurance that the Bank will be able to comply fully with the provisions of the Formal Agreement, and the determination of our compliance will be made by the OCC. However, management believes the Bank is currently in substantial compliance with the Formal Agreement. Failure to meet the requirements of the Formal Agreement could result in additional regulatory requirements, which could result in regulators taking additional enforcement actions against the Bank.

Memorandum of Understanding. On June 15, 2010 the Company entered into a memorandum of understanding (the MOU) with the Federal Reserve Bank of Richmond. The MOU includes, among other things, a requirement that the Company obtain the prior written approval of the Federal Reserve Bank of Richmond before declaring or paying any dividends; appointing any new director or senior executive officer, or changing the position of any senior executive officer; directly or indirectly accepting dividends or any other form of payment representing a reduction in capital from the Bank; directly or indirectly, incurring, increasing or guaranteeing any debt; and directly or indirectly, purchasing or redeeming any shares of its stock. We have complied with all of the requirements of the MOU. While there can be no assurances regarding future responses, the Federal Reserve Bank of Richmond has approved our request to pay dividends for each quarter since the inception of the MOU.

Evaluation of Potential Charter Conversion. The Bank operates as a national banking association incorporated under the laws of the United States and subject to examination by the OCC. The Bank is currently exploring whether to convert from a federally-chartered national bank to a South Carolina-chartered commercial bank. The Bank believes that a conversion to a state-chartered bank would, among other things, reduce certain regulatory expenses and potentially eliminate certain of the restrictions on the Bank s ability to pay cash dividends to the Company. No assurances can be made that regulatory expenses would decrease or that the Bank would be permitted to pay cash dividends to the Company in the future in the event of a conversion. Conversion to a South Carolina-chartered bank would be subject to regulatory approval. In the event the Bank converted its charter to a state bank, the Bank would be subject to regulation by both the South Carolina Board of Financial Institutions and the Federal Deposit Insurance Corporation (the FDIC) rather than the OCC. The Bank s deposits would continue to be fully insured by the FDIC in accordance with applicable laws and regulations.

34

Table of Contents

Strategic Developments

The Bank expanded its residential mortgage business unit with the acquisition of the assets of Palmetto South Mortgage Corporation (Palmetto South), effective July 31, 2011. Palmetto South, which operates as a division of the Bank, offers mortgage loan products for home purchase or refinance in the South Carolina market area. The acquisition price will be paid during a three year earn out period with the actual amount calculated based on the achievement of certain profitability metrics. The earn out terms over the three year period provide for contingent consideration which ranges from $0 to $1.2 million based upon annual net income. Management anticipates the amount will be approximately $600 thousand based upon recent past operating results. The purchase price of operating assets was $22 thousand.

Comparison of Results of Operations for Nine Months Ended September 30, 2011 to the Nine Months Ended September 30, 2010

Net Income

Our net income for the nine months ended September 30, 2011 was $2.3 million, or $0.53 diluted earnings per common share, as compared to $1.5 million, or $0.29 diluted earnings per common share, for the nine months ended September 30, 2010. The increase in net income between the two periods is primarily due to a decrease in the provision for loan losses of $255thousand and an increase of $1.7 million in non-interest income. These were partially offset by a $730 thousand increase in non-interest expense during the nine months ended September 30, 2011 as compared to the same period in 2010. Non-interest income increased as a result of significantly lower OTTI write-downs on securities, a lower negative fair value adjustment on our interest rate swap as well as increases in both mortgage origination fees and fees on non-deposit investment products in the first nine months of 2011 as compared to the same period in 2010. Average earning assets decreased $5.3 million to $550.1 million during the nine months ended September 30, 2011 from $555.4 million during the nine months ended September 30, 2010. The decrease in average earning assets was primarily a result paying down Federal Home Loan Bank advances of $19.4 million during the nine months ended September 30, 2011.

Net Interest Income

Please refer to the table at the end of this Item 2 for the yield and rate data for interest-bearing balance sheet components during the nine-month periods ended September 30, 2011 and 2010, along with average balances and the related interest income and interest expense amounts.

Net interest income was $13.7 million for the nine months ended September 30, 2011. The decrease in the earning assets was offset by a 4 basis point improvement in the net interest margin during the nine months ended September 30, 2011 as compared to the same period in 2010. Net interest margin on a taxable equivalent basis increased from 3.31% at September 30, 2010 to 3.33% at September 30, 2011. The yield on earning assets decreased by 33 basis points in the first nine months of 2011 as compared to the same period in 2010. The yield on earning assets for the nine months ended September 30, 2011 and 2010 was 4.69% and 5.02%, respectively. The cost of interest-bearing liabilities during the first nine months of 2011 was 1.58% as compared to 1.98% in the same period of 2010, resulting in a 40 basis points decrease. Continued low loan demand has resulted in loans comprising 60.0% of average earning assets in the first nine months of 2011 as compared to 61.1% in the same period of 2010. The lower average loan balances as well as reinvesting cash flows from maturing loans and investments at interest rates that have continued to decline over the last year have resulted in the 33 basis point decline in the yield on earning assets during the two periods. Our cost of funds has declined by 40 basis points on average in the first nine months of 2011 as compared to the same period of 2010.

Interest-bearing transaction accounts, money market accounts and savings deposits, which are typically our lower costing funds, represent 34.2% of our average interest bearing liabilities during the first nine months of 2011 as compared to 29.1% in the same period of 2010. Time deposits and borrowed funds, typically the higher costing funds, represent 65.8% of our average interest-bearing funds in the first nine months of 2011 as compared to 70.9% during the same period in 2010. The continued improvement in the overall mix of our funding sources has contributed to the reduction in our cost of funds during the first nine months of 2011 as compared to the same period in 2010.

Table of Contents

Provision and Allowance for Loan Losses

At September 30, 2011 and December 31, 2010, the allowance for loan losses was $4.7 million or 1.45% of total loans and $4.9 million or 1.49% of total loans, respectively. Our provision for loan losses was $1.1 million for the nine months ended September 30, 2011, as compared to $1.4 million for the nine months ended September 30, 2010. This provision is made based on our assessment of general loan loss risk and asset quality. The allowance for loan losses represents an amount which we believe will be adequate to absorb probable losses on existing loans that may become uncollectible. Our judgment as to the adequacy of the allowance for loan losses is based on a number of assumptions about future events, which we believe to be reasonable, but which may or may not prove to be accurate. Our determination of the allowance for loan losses is based on evaluations of the collectability of loans, including consideration of factors such as the balance of impaired loans, the quality, mix, and size of our overall loan portfolio, the experience, ability and depth of lending personnel, economic conditions (local and national) that may affect the borrower s ability to repay, the amount and quality of collateral securing the loans, our historical loan loss experience, and a review of specific problem loans. We also consider subjective issues such as changes in the lending policies and procedures, changes in the local/national economy, changes in volume or type of credits, changes in volume/severity of problem loans, quality of loan review and board of director oversight, and concentrations of credit. Periodically, we adjust the amount of the allowance based on changing circumstances. We charge recognized losses to the allowance and add subsequent recoveries back to the allowance for loan losses.

We perform an analysis quarterly to assess the risk within the loan portfolio. The portfolio is segregated into similar risk components for which historical loss ratios are calculated and adjusted for identified changes in current portfolio characteristics. Historical loss ratios are calculated by product type and by regulatory credit risk classification. The allowance consists of an allocated and unallocated allowance. The allocated portion is determined by types and ratings of loans within the portfolio. The unallocated portion of the allowance is established for losses that exist in the remainder of the portfolio and compensates for uncertainty in estimating the loan losses. The annualized weighted average loss ratios over the 24 month period ended September 30, 2011 for loans classified substandard, special mention and pass were approximately 6.55%, 3.30% and 0.39%, respectively. The unallocated portion of the allowance as a percentage of the total allowance has grown over the last several years. The allocated portion of the allowance is based on historical loss experience as well as certain qualitative factors as explained above. The qualitative factors have been established based on certain assumptions, including the current economic conditions and as conditions change are adjusted to be directionally consistent with these changes. Given the ongoing uncertainty in economic conditions and particularly real estate valuations, we do not believe it would be prudent to reduce substantially the overall level of our allowance at this time. As economic conditions show sustainable improvement, the unallocated portion of the allowance should decrease as a percentage of the total allowance. In the near term this percentage may continue to increase slightly.

There can be no assurance that charge-offs of loans in future periods will not exceed the allowance for loan losses as estimated at any point in time or that provisions for loan losses will not be significant to a particular accounting period. The allowance is also subject to examination and testing for adequacy by regulatory agencies, which may consider such factors as the methodology used to determine adequacy and the size of the allowance relative to that of peer institutions. Such regulatory agencies could require us to adjust our allowance based on information available to them at the time of their examination.

The decrease in the provision for the first nine months of 2011 as compared to the same period in 2010 is a result of stabilizing levels of our classified and non-performing loans as well as some moderate improvement in economic conditions, including unemployment levels, in our markets. Our loan portfolio consists of a large percentage of real estate secured loans. Real estate values continue to be adversely impacted as a result of the economic downturn over the last several years. Impaired values of the underlying real estate collateral as well as continued slowdown in both residential and commercial real estate sales impacts our ability to sell collateral upon foreclosure. There is a risk that this trend will continue. The real estate collateral in each case provides an alternate source of repayment in the event of default by the borrower and may deteriorate in value during the time the credit is extended. If real estate values continue to decline, it is also more likely that we would be required to increase our allowance for loan losses. If during a period of reduced real estate values we are required to liquidate the property collateralizing a loan to satisfy the debt or to increase the allowance for loan losses, it could materially reduce our profitability and adversely affect our financial condition.

The effects of the ongoing slowdown in the economy continue to result in ongoing stress to our loan portfolio as evidenced by higher levels of non-performing assets than we have historically experienced. Non-performing assets were $11.7 million (1.93% of total assets) at September 30, 2011 as compared to $13.2 million (2.20% of total assets) at December 31, 2010. While we believe these ratios are favorable in comparison to current industry results, we continue to be concerned about the impact of this economic environment on our customer base of local businesses and

Table of Contents

professionals. There are 32 loans included in non-performing status (nonaccrual loans and loans past due 90 days and still accruing) totaling $3.4 million. The two largest loans are in the amount of $592 thousand and $601 thousand. The first relationship in the amount of $592 thousand is a first mortgage on a number of investment condominium units and the second in the amount of $661 thousand is a first lien on an apartment complex. These loans have been placed on a nonaccrual status. In both cases, we have obtained additional collateral to support the loan and give the borrowers additional time to work through their current cash flow problems. Based on the current valuations of the underlying collateral and the additional collateral, it is not anticipated that we will incur a material loss if we are required to foreclose on the property in the future. The average balance of the remaining 30 loans is approximately $75 thousand, and the majority of these loans are secured by first mortgage liens. At the time the loans are placed in nonaccrual status, we typically obtain an updated evaluation and generally write the balance down to the fair value if the loan balance exceeds fair value. At September 30, 2011, we had no loans delinquent more than 90 days and still accruing interest, and loans totaling $3.1 million (0.95% of total loans) that were delinquent 30 days to 89 days. Included in performing loans are six loans totaling $6.1 million that are considered to be TDRs and are accruing interest. Two of the accruing TDRs total $5.3 million. The first in the amount of $3.1 million is a loan secured real estate and was modified on a temporary basis. It is believed that this loan will return to its previous repayment structure at the end of the modification period. The second is in the amount of $2.2 million and is secured by commercial real estate. Both of these loans are current and performing under the modification terms at September 30, 2011.

Our management continuously monitors non-performing, classified and past due loans, to identify deterioration regarding the condition of these loans. We have identified three loan relationships in the amount of $1.7 million that are current as to principal and interest and not included in non-performing assets that could represent potential problem loans. These loans are secured primarily by first liens on investment rental or owner occupied commercial properties and it is not anticipated that we would have a material loss in the event we should subsequently foreclose on the properties.

Table of Contents

The following table summarizes the activity related to our allowance for loan losses:

Allowance for Loan Losses

(Dollars in thousands)	Nine months Ended September 30, 2011	2010
Average loans outstanding	$ 329,843	$ 339,140
Loans outstanding at period end	$ 324,233	$ 329,713
Non-performing assets:		
Nonaccrual loans	$ 3,408	$ 5,652
Loans 90 days past due still accruing		340
Foreclosed real estate	8,269	7,373
Total non-performing assets	$ 11,677	$ 13,365
Beginning balance of allowance	$ 4,911	$ 4,854
Loans charged-off:		
Construction and development		
1-4 family residential mortgage	142	901
Multi-family residential		
Non-residential real estate	683	222
Home equity	247	157
Commercial	239	92
Installment & credit card	57	109
Total loans charged-off	1,368	1,481
Recoveries:		
1-4 family residential mortgage	4	42
Non-residential real estate		2
Home equity	4	6
Commercial	27	23
Installment & credit card	20	30
Total recoveries	55	103
Net loan charge offs	1,313	1,378
Provision for loan losses	1,110	1,365
Balance at period end	$ 4,708	$ 4,841
Net charge -offs to average loans	0.40%	0.41%
Allowance as percent of total loans	1.45%	1.47%
Non-performing assets as % of total assets	1.92%	2.19%
Allowance as % of non-performing assets	40.32%	36.22%

Table of Contents

The following allocation of the allowance to specific components is not necessarily indicative of future losses or future allocations. The entire allowance is available to absorb losses in the portfolio.

Composition of the Allowance for Loan Losses

	September 30, 2011		December 31, 2010	
(Dollars in thousands)	**Amount**	**% of loans in Category**	**Amount**	**% of loans in Category**
Commercial, Financial and Agricultural	$ 316	6.2%	$ 681	6.2%
Real Estate Construction	384	2.8%	905	3.2%
Real Estate Mortgage:				
Commercial	1,583	68.3%	1,404	66.2%
Residential	454			