HIGHLANDS BANKSHARES INC /VA/
Form 10-K
March 29, 2013

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

FORM 10-K

Annual Report Pursuant to Section 13 or 15(d)
of the Securities Exchange Act of 1934

For the fiscal year ended December 31, 2012

Commission File Number 000-27622

HIGHLANDS BANKSHARES, INC.
(Exact name of registrant as specified in its charter)

Virginia (State or other jurisdiction of incorporation or organization)	54-1796693 (I.R.S. Employer Identification No.)
340 West Main Street Abingdon, Virginia (Address of principal executive offices)	24210-1128 (Zip Code)

Registrant's telephone number, including area code: (276) 628-9181

Securities registered pursuant to Section 12(g) of the Act:
Common Stock, $0.625 par value
(Title of class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No x
Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes o No x
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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. x
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or smaller reporting company. (See definition of "large accelerated filer, accelerated filer and smaller reporting company" in Rule 12b-2 of the Act). Large Accelerated Filer o Accelerated Filer o Non-Accelerated Filer o Smaller Reporting Company x
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act) Yes o No x
State the aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold, or the average bid and asked price of such common equity, as of the last business day of the registrant's most recently completed second fiscal quarter. $9,625,243.

Indicate the number of shares outstanding of each of the registrant's classes of common stock as of the latest practicable date. As of March 13, 2013, there were 5,011,152 shares of Common Stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Consolidated Financial Report for year ended December 31, 2012 – Part II
Proxy Statement for the 2013 Annual Meeting of Shareholders—Part III

Table of Contents

Part I.

Item 1. Business

History and Business

Highlands Bankshares, Inc. (the "Company") is a one-bank holding company organized under the laws of Virginia in 1995 and registered under the Federal Bank Holding Company Act of 1956 ("BHCA"). The Company conducts the majority of its business operations through its wholly-owned bank subsidiary, Highlands Union Bank (the "Bank"). The Company has two direct subsidiaries as of December 31, 2012: the Bank, which was formed in 1985, and Highlands Capital Trust I ("HCTI"), a statutory business trust (the "Trust") which was formed in 1998.

Highlands Union Bank

The Bank is a Virginia state chartered bank that was incorporated in 1985. The Bank operates a commercial banking business from its headquarters in Abingdon, Virginia, and its thirteen area full service branch offices. The Bank offers general retail and commercial banking services to individuals, businesses and local government unit customers. These products and services include accepting deposits in the form of checking accounts, money market deposit accounts, interest-bearing demand deposit accounts, savings accounts and time deposits; making residential 1-4 family loans, owner occupied and non owner occupied commercial real estate loans, second mortgages and equity lines, consumer, commercial and industrial, credit card and agricultural loans; offering letters of credit; providing other consumer financial services, such as automatic funds transfer, collections, night depository, safe deposit, travelers checks and savings bond sales; and providing other miscellaneous services normally offered by commercial banks.

Highlands Union Insurance Services, Inc.

Highlands Union Insurance Services, Inc., ("HUIS") a wholly owned subsidiary of the Bank, was formed in 1999. The Bank, through HUIS, joined a consortium of approximately forty-seven other financial institutions to form Bankers' Insurance, LLC. Bankers' Insurance, LLC, as of December 31, 2012, had purchased twelve full service insurance agencies across the state of Virginia. HUIS sells insurance products and services through Bankers' Insurance, LLC. The number of owner banks involved with Bankers' Insurance, LLC was thirty-three as of December 31, 2012.

Highlands Union Financial Services, Inc.

Highlands Union Financial Services, Inc., a wholly-owned subsidiary of the Bank, was created to offer third party mutual funds and other financial services to its customers in all market areas served by the Bank. The only activity in Highlands Union Financial Services Inc. now relates to commissions from the sale of life insurance.

In February 2005, the Bank became an equity owner in Bankers' Investments, LLC, headquartered in Richmond, Virginia. Bankers' Investments, LLC was formed for the purpose of providing owner banks the ability to offer a full line of financial services to their customers. During 2007, Bankers Investments was acquired by Infinex, LLC, a full service provider of a wide array of investment services. Infinex, LLC is owned by member banks and banking associations.

Lending Activities

The Bank has written policies and procedures to help manage credit risk. The Bank's policy provides for three levels of lending authority. The first level of authority is granted to individual loan officers who have various levels of approval based upon their position and experience. The second level is the Senior Officers Loan Committee, which is comprised of senior officers of the Bank from all market areas. The Senior Officers Loan Committee considers loans that exceed the individual loan officers' lending authority and reviews loans to be presented to the Directors Loan Committee. The Directors Loan Committee is comprised of six Directors, four of which are independent Directors. The Directors Loan Committee approves new, modified and renewed credits that exceed the Senior Officer Loan Committee authorities. The Chairman of the Directors Loan Committee is the Chairman of the Company. A quorum is reached when four committee members are present, of which at least three must be independent Directors. An application requires four votes to receive approval by the Committee. In addition, monthly, the Directors Loan Committee reports all new loans reviewed and approved to the Bank's Board of Directors. Monthly reports shared by the Directors Loan Committee include names and amounts of all new credits extended; a watch list including names, amounts, risk rating; non- accrual loans and recommended loans to be charged off and a list of overdrafts. The Directors Loan Committee also reviews changes to lending policies as proposed by management prior to submission to the Board of Directors for approval.

The Bank has an internal Credit Review Department that reviews the Bank's loan portfolio to identify loss exposure and to monitor compliance with the Bank's loan policy. An analysis of loss exposure and reports on policy compliance are presented to the Directors Loan Committee of the Board for approval on a quarterly basis.

One-to-Four-Family Residential Real Estate Lending

Residential loan opportunities may be generated by the Bank's loan officers, referrals by real estate professionals, and by existing or new bank clients. Loan applications are taken by a Bank loan officer. As part of the application process, information is gathered concerning income, employment and credit history of the applicant and originations are underwritten using policy including a loan to value ("LTV") of 80% of appraised value. Security for the majority of one to four family residential loans is owner occupied single family dwellings. Values of residential real estate collateral are provided by independent appraisers who have been approved by the Bank's Board of Directors.

Second mortgages and Home Equity Lines of Credit are generated, underwritten and secured like single family residential real estate loans discussed above. However, both second mortgages and Home Equity Lines of Credit are made at higher interest rates than residential mortgages. In the event that LTV is greater than 80%, the loan request is reviewed by the Senior Officers' Loan Committee and the Board of Directors, depending on the amount of the loan. Second mortgages are typically made for no more than fifteen years and equity lines mature in 10 years.

The Bank also originates adjustable rate products ("ARM") secured by one to four family residential properties with a term of one, three, or five years. These products provide another outlet instead of secondary market loans and are generated, underwritten and secured the same as single family residential real estate loans discussed above. The Bank retains these loans in its loan portfolio. Senior Management adjusts the ARM rates based on competitive rates within the Bank's market area. The ARM products contain interest rate caps at adjustment periods and rate ceilings based on a cap over and above the original interest rate. Adjustable rate mortgages are underwritten based on payment amounts at the interest rate reaching the lifetime cap.

At December 31, 2012, $185 million, or 47%, of the Bank's loan portfolio consisted of one-to four-family residential real estate loans, second mortgages, and home equity lines. Of the $185 million, $96 million were fixed rate mortgages while the remaining $89 million were adjustable rate mortgages. The fixed rate loans are typically 3, 5, and 7 year balloon loans amortized over a 30 year period. In connection with residential real estate loans, Highlands Union Bank requires title insurance, hazard insurance and if required, flood insurance.

Multifamily Residential Estate Lending

Loan applications for loans to be secured by multi-family residential properties are taken by a loan officer. As part of the application process, information is gathered concerning income, employment and credit history of the applicant, as well as rent rolls, operating costs and occupancy rates of the property to be financed. Loan originations are underwritten using the Bank's underwriting guidelines of a LTV of 80% and a cash flow coverage ratio of 1.10 or better. The valuation of multifamily residential collateral is provided by independent fee appraisers who have been approved by the Bank's Board of Directors.

The Bank originates fixed rate and adjustable rate loans secured by multi-family properties, which are retained in the Bank's portfolio. Adjustable rate mortgages are underwritten based on payment amounts at the interest rate reaching the lifetime cap.

Commercial, Construction, Farmland, Other Land Loans and Land Development Lending

The Bank makes commercial, construction, farmland and land acquisition and development loans. These loans generally have a higher degree of risk than residential mortgage loans, but also have higher yields. To minimize these risks, the Bank normally obtains appropriate collateral and requires the personal guarantees from the borrower's principal owners and monitors the financial condition of its business borrowers. Commercial business loans typically are made on the basis of the borrower's ability to make repayment from cash flow from its business. As a result, the availability of funds for the repayment of commercial business loans is substantially dependent on the success of the business itself. Furthermore, the collateral for commercial business loans may depreciate over time and generally cannot be appraised with as much precision as historically been the case with residential real estate.

At December 31, 2012, commercial real estate loans aggregated $100 million, or 26%, of Highlands Union Bank's total loans. In its underwriting of commercial real estate, the Bank may lend, under its policy, up to 75% of the secured property's appraised value. The Bank's commercial real estate loan underwriting criteria require an examination of debt service coverage ratios and the borrower's creditworthiness, prior credit history and reputation. The Bank also evaluates the location of the secured property, and as noted above, typically requires personal guarantees or endorsements of the borrowing entity's principal owners.

Construction and Land Development loans, including acquisition and development loans, are primarily those secured by residential houses and commercial structures under construction and the underlying land for which the loan was obtained. Over the past two years the Bank has significantly reduced the number of originations of construction and land development loans in all of its market areas in an effort to reduce portfolio risk.

At December 31, 2012, construction, farmland, and other land loans outstanding were $30 million, or 8%, of total loans. Construction lending entails significant additional risks and often involves larger loan balances concentrated with single borrowers or groups of related borrowers. Another risk involved in construction lending is attributable to the fact that loan funds are advanced to fund construction, the value of which is estimated prior to the completion of construction on "as built" basis. Therefore, it is difficult to accurately estimate the total loan funds required to complete the project and the completed loan-to-value ratios. To mitigate the risks associated with construction lending, the Bank generally limits loan amounts to 75% of as built appraised value, in addition to analyzing the creditworthiness of its borrowers. The Bank obtains a first lien on the property as security for construction loans, monitors the construction and advance process and, if a business entity, typically requires personal guarantees from the borrowing entity's principal owners.

Commercial and Agricultural Lending-- Non-Real Estate Secured and Unsecured

The Bank makes local commercial and agricultural unsecured and non-real estate secured loans. These loans generally have a higher degree of risk than other loans and to manage these risks, the Bank generally obtains collateral, such as inventories, accounts receivable, equipment and personal guarantees from the borrowing entity's principal owners. In its underwriting of commercial and agricultural non-real estate secured loans, the Bank may lend, under internal policy, up to 80% of the secured collateral appraised value. The Bank's commercial and agricultural non-real estate secured underwriting criteria require adequate debt service coverage ratios and the borrower's creditworthiness, prior credit history and reputation. As commercial business and agricultural non-real estate secured loans typically are made on the basis of the borrower's ability to make repayment from cash flow, the availability of funds for the repayment is substantially dependent on the success of the business itself.

At December 31, 2012, commercial and agricultural non-real estate secured loans including unsecured loans aggregated $35 million, or 9%, of the Bank's total loans.

Consumer Lending-Non Real Estate Secured and Unsecured

The Bank offers various secured and unsecured consumer loans, including unsecured personal loans and lines of credit, automobile loans, deposit account loans made on both an installment and demand basis. At December 31, 2012, the Bank had consumer loans of $22 million or 6% of gross loans. Such loans are generally made to customers with whom the Bank has a pre-existing relationship, often deposit and residential mortgage relationships. The Bank only originates its consumer loans in its geographic market area. The underwriting standards employed by the Bank for consumer loans include a determination of the applicant's payment history on other debts and an assessment of the ability to meet existing obligations and payments on the proposed loan. The stability of the applicant's monthly income may be determined by the verification of gross monthly income from primary employment and additionally from any verifiable secondary source. The applicant's FICO scores are also analyzed with the credit report analysis. Although creditworthiness of the applicant is of primary consideration, the underwriting process also includes an analysis of the value of the available collateral, if applicable.

Consumer loans may entail significant risk, particularly if unsecured, such as lines of credit, or secured by rapidly depreciable assets such as automobiles. In such cases, any repossessed collateral for a defaulted consumer loan may not provide an adequate source of repayment of the outstanding loan balance. The remaining deficiency often does not warrant further substantial collection efforts against the borrower. In addition, consumer loan collections are dependent on the borrower's continuing financial stability, and thus are more likely to be adversely affected by job loss, divorce, illness or personal bankruptcy. Furthermore, the application of various federal and state laws, including bankruptcy and insolvency laws, may limit the amount which can be recovered on such loans. Such loans may also give rise to claims and defenses by a consumer borrower against an assignee of collateral securing the loan such as the Bank and a borrower may raise claims which it has against the seller of the underlying collateral to prevent collection.

Participation Loans

The Bank will occasionally buy or sell all or a portion of a loan. The Bank will consider selling a loan or a participation in a loan, if: (i) the full amount of the loan to a single borrower will exceed the Bank's legal lending limit, which is 15 percent of the unimpaired capital and unimpaired surplus of the Bank; (ii) the full amount of the loan, when combined with a borrower's previously outstanding loans, will exceed the Bank's legal lending limit to a single borrower; (iii) the Board of Directors or the Senior Officer Loan Committee believes that a particular borrower has a sufficient level of debt with the Bank; (iv) the borrower requests the sale; (v) the loan to deposit ratio is at or above the optimal level as determined by Bank management; and/or (vi) the loan may create too great a concentration of loans in one particular location, one industry or in one particular type of loan. The Bank will consider purchasing a participation in a loan from another financial institution if the loan meets all applicable credit quality standards and (i) the Bank's loan to deposit ratio is at a level where additional loans would be desirable; and/or (ii) a common customer requests the purchase.

The following table sets forth, for the two fiscal years ended December 31, 2012 and 2012, the percentage of total operating revenue contributed by each class of similar services which contributed 15% or more of total operating revenues of the Company during such periods.

Period	Class of Service	Percentage of Total Revenues
December 31, 2012	Interest and Fees on Loans	76.84%
December 31, 2011	Interest and Fees on Loans	77.61%

Market Area

Highlands Union Bank Market Area

The Bank’s primary market area consists of:

- all of Washington County, Virginia
- portions of Smyth County, Virginia
- the City of Bristol, Virginia
- the City of Bristol, Tennessee and adjacent portions of Sullivan County, Tennessee
- the Town of Rogersville, Tennessee and adjacent portions of Hawkins County, Tennessee
- the City of Sevierville, Tennessee and adjacent portions of Sevier County, Tennessee,

- the City of Knoxville, Tennessee and adjacent portions of Knox County, Tennessee
- the Town of Banner Elk and adjacent portions of Avery County, North Carolina
- the Town of Boone and adjacent portions of Watauga County, North Carolina

The independent city of Bristol, Virginia is located in far southwestern Virginia and lies directly on the Virginia-Tennessee state line. Washington County surrounds Bristol to the west, north and east. In the Bristol/Washington County community, manufacturing, sales, and professional services sectors are the largest industries, in terms of total number of jobs in 2012. These sectors contribute in total 66.1% of the total employment. The latest unemployment figures as of December 2012 reflect an unemployment rate of 9.1% and 7.1% for the Bristol, Virginia and Washington County, Virginia respectively.

The Bank has a branch office located in Marion which is the county seat of Smyth County, Virginia. Marion is approximately 30 miles northeast of Abingdon, Virginia. The latest unemployment figures reflect an unemployment rate of 8.7% reported as of December 2012. In Smyth County, manufacturing, sales, and professional services sectors are the largest industries, in terms of total number of jobs in 2012. These sectors contribute in total 66.5% of the total employment.

Bristol, Tennessee is located in Sullivan County, Tennessee and is Bristol, Virginia’s twin city. Bristol, Tennessee’s three largest employment sectors are services, manufacturing and retail trade. The latest unemployment figures reflect an unemployment rate of 7.10% as of December 2012. The sales, professional services, and manufacturing sectors make up 65.1% of all jobs throughout the County.

Rogersville, Tennessee is located in Hawkins County approximately 45 miles southwest of Bristol, Tennessee. Rogersville is the county seat for Hawkins County. Rogersville’s and Hawkins County’s largest employment sectors are professional services and manufacturing. These sectors combined make up 68.9% of all jobs throughout the County. The latest unemployment figures reflect an unemployment rate of 7.5% as of December 2012.

Sevierville, Tennessee is located in Sevier County, Tennessee. Sevierville, Tennessee is located approximately 20 miles east of Knoxville, Tennessee. Sevierville serves as the county seat and is the largest city located in Sevier County. Major employers for the County include tourism, retail sales, and service related industries, which make up 61.8% of all jobs throughout the County. There is some industrial base that mitigates some of the seasonal employment fluctuation from the tourism and related businesses. The latest unemployment figures reflect an unemployment rate of 8.4% as of December 2012.

Knoxville, Tennessee is located in Knox County, Tennessee. Knoxville, Tennessee is located approximately 20 miles west of Sevierville, Tennessee. Knoxville serves as the county seat and is the third largest city in the state of Tennessee. Major employers for the County include professional services, professional occupations, and sales. These sectors contribute to 69.4% of all jobs in the County. The latest unemployment figures reflect an unemployment rate of 6.3% as of December 2012. Knoxville’s central location to two major interstate highways which link the eastern half of the United States continues to provide many opportunities for economic growth in the future.

Banner Elk, North Carolina is located in Avery County in the northwestern mountains of North Carolina. Avery County, North Carolina had an estimated population of 17,797 as of December 2012. In Avery County, sales, manufacturing and professional services are the largest industries, in terms of total number of jobs in 2012. The latest unemployment figures reflect an unemployment rate of 10.9% as of December 2012.

Boone, North Carolina is located in Watauga County in the northwestern mountains of North Carolina. Watauga County, North Carolina has an estimated population of 51,079 as of December 2012. Watauga County's three largest employment sectors are professional services, professional occupations, and sales. The latest unemployment figures reflect an unemployment rate of 7.2% as of December 2012.

Competition

The banking and financial service business in Virginia, North Carolina and Tennessee generally, and in the Bank's market areas specifically, is highly competitive. The increasingly competitive environment is a result of changes in regulation, changes in technology and product delivery systems and new competition from non-traditional financial services. The Bank competes for loans and deposits with other commercial banks, savings and loan associations, securities and brokerage companies, mortgage companies, money market funds, credit unions and other non-bank financial service providers. Many of these competitors are much larger in total assets and capitalization, have greater access to capital markets and offer a broader array of financial services than the Bank. In order to compete, the Bank relies upon service-based business philosophies, personal relationships with customers, specialized services tailored to meet customers' needs and the convenience of office locations and extended hours of operation. In addition, the Bank is generally competitive with other financial institutions in its market areas with respect to interest rates paid on deposit accounts, interest rates charged on loans and other service charges on loans and deposit accounts. Deposit market share for each of the Bank's market areas can be found on the FDIC's website at www.fdic.gov under the Industry Analysis/Summary of Deposits section.

Certain Regulatory Considerations

The Company and the Bank are subject to various state and federal banking laws and regulations which impose specific requirements or restrictions on and provide for general regulatory oversight with respect to virtually all aspects of operations. As a result of the substantial regulatory burdens on banking, financial institutions, including the Company and the Bank, are disadvantaged relative to other competitors who are not as highly regulated, and their costs of doing business are much higher.

The following is a summary of the material provisions of certain statutes, rules and regulations which affect the Company and the Bank. This summary is qualified in its entirety by reference to the particular statutory and regulatory provisions referred to below, and is not intended to be an exhaustive description of the statutes or regulations which are applicable to the business of the Company and the Bank. Any change in applicable laws or regulations may have a material adverse effect on the business and prospects of the Company and the Bank.

Highlands Bankshares, Inc.

The Company is a bank holding company within the meaning of the BHCA and a financial institution holding company within the meaning of Chapter 7 of the Virginia Banking Act, as amended (the Virginia Banking Act). The activities of the Company also are governed by the Gramm-Leach-Bliley Act of 1999.

The Bank Holding Company Act. The BHCA is administered by the Federal Reserve Board, and the Company is required to file with the Federal Reserve Board an annual report and any additional information the Federal Reserve Board may require under the BHCA. The Federal

8

Reserve Board also is authorized to examine the Company and its subsidiaries. The BHCA requires every bank holding company to obtain the approval of the Federal Reserve Board before (i) it or any of its subsidiaries (other than a bank) acquires substantially all the assets of any bank; (ii) it acquires ownership or control of any voting shares of any bank if after the acquisition it would own or control, directly or indirectly, more than 5% of the voting shares of the bank; or (iii) it merges or consolidates with any other bank holding company.

The BHCA and the Change in Bank Control Act, together with regulations promulgated by the Federal Reserve Board, require that, depending on the particular circumstances, either Federal Reserve Board approval must be obtained or notice must be furnished to the Federal Reserve Board and not disapproved prior to any person or company acquiring "control" of a bank holding company, such as the Company, subject to certain exemptions. Control is conclusively presumed to exist if an individual or company acquires 25% or more of any class of voting securities of the Company. Control is presumed to exist (but rebuttable) if a person acquires 10% or more, but less than 25%, of any class of voting securities of the Company. The regulations provide a procedure for challenging the rebuttable control presumption.

Under the BHCA, a bank holding company is generally prohibited from engaging in, or acquiring direct or indirect control of more than 5% of the voting shares of any company engaged in non-banking activities, unless the Federal Reserve Board, by order or regulation, has found those activities to be so closely related to banking or managing or controlling banks as to be incident to banking. The Federal Reserve Board imposes certain capital requirements on the Company under the BHCA, including a minimum leverage ratio and a minimum ratio of "qualifying" capital to risk-weighted assets. Subject to its capital requirements and certain other restrictions, the Company can borrow money to make a capital contribution to the Bank, and these loans may be repaid from dividends paid from the Bank to the Company (although the ability of the Bank to pay dividends are subject to regulatory restrictions). The Company can raise capital for contribution to the Bank by issuing securities without having to receive regulatory approval, subject to compliance with federal and state securities laws.

The Gramm-Leach-Bliley Act. The Gramm-Leach-Bliley Act (the GLBA) permits significant combinations among different sectors of the financial services industry; allows for significant expansion of financial service activities by bank holding companies and provides for a regulatory framework by various governmental authorities responsible for different financial activities; and offers certain financial privacy protections to consumers. The GLBA repealed affiliation and management interlock prohibitions of the Depression-era Glass-Steagall Act and, by amending the Bank Holding Company Act, the GLBA added new substantive provisions to the non-banking activities permitted under the BHCA with the creation of the financial holding company. The GLBA preempts most state laws that prohibit financial holding companies from engaging in insurance activities. The GLBA permits affiliations between banks and securities firms within the same holding company structure, and the GLBA permits financial holding companies to directly engage in a broad range of securities and merchant banking activities. The Company has not elected to become a financial holding company. The Gramm-Leach-Bliley Act has led to important changes in the manner in which financial services are delivered in the United States. Bank holding companies and their subsidiary banks are able to offer a much broader array of financial services; however, there is greater competition in all sectors of the financial services market.

The Virginia Banking Act. All Virginia bank holding companies must register with the Virginia State Corporation Commission (the “Commission”) under the Virginia Banking Act. A registered bank holding company must provide the Commission with information with respect to the financial condition, operations, management and inter-company relationships of the holding company and its subsidiaries. The Commission also may require such other information as is necessary to keep informed about whether the provisions of Virginia law and the regulations and orders issued under Virginia law by the Commission have been complied with, and may make examinations of any bank holding company and its subsidiaries. The Virginia Banking Act allows bank holding companies located in any state to acquire a Virginia bank or bank holding company if the Virginia bank or bank holding company could acquire a bank holding company in their state and the Virginia bank or bank holding company to be acquired has been in existence and continuously operated for more than two years. The Virginia Banking Act permits bank holding companies from throughout the United States to enter the Virginia market, subject to federal and state approval.

Sarbanes-Oxley Act of 2002. The Sarbanes-Oxley Act of 2002 (the "SOX Act") implemented legislative reforms intended to address corporate and accounting fraud. In addition to the establishment of a new accounting oversight board that enforces auditing, quality control and independence standards and is funded by fees from all publicly traded companies, the law restricts provision of both auditing and consulting services by accounting firms. To ensure auditor independence, any non-audit services being provided to an audit client requires pre-approval by the issuer's audit committee members and the SOX Act also restricts certain services that the audit firm may perform. In addition, audit partners must be rotated. The SOX Act requires chief executive officers and chief financial officers, or their equivalent, to certify to the accuracy of periodic reports filed with the SEC, subject to civil and criminal penalties if they knowingly or willfully violate this certification requirement. In addition, under the SOX Act, legal counsel is required to report evidence of a material violation of the securities laws or a breach of fiduciary duty by a company to its chief executive officer or its chief financial officer, and, if such officer does not appropriately respond, to report such evidence to the audit committee or other similar committee of the board of directors or the board itself.

Dodd-Frank Act. On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), which significantly changes the regulation of financial institutions and the financial services industry. The Dodd-Frank Act included several provisions that will affect how community banks, thrifts, and small bank and thrift holding companies will be regulated in the future. Among other things, these provisions abolished the Office of Thrift Supervision and transferred its functions to the other federal banking agencies, relaxed rules regarding interstate branching, allows financial institutions to pay interest on business checking accounts, changed the scope of federal deposit insurance coverage, and impose new capital requirements on bank and thrift holding companies. The Dodd-Frank Act also established the Bureau of Consumer Financial Protection as an independent entity within the Federal Reserve, which is given the authority to promulgate consumer protection regulations applicable to all entities offering consumer financial services or products, including banks. Additionally, the Dodd-Frank Act includes a series of provisions covering mortgage loan origination standards affecting originator compensation, minimum repayment standards, and pre-payments.

Highlands Union Bank.

General. The Bank, as a state chartered member of the Federal Reserve, is subject to regulation and examination by the Virginia State Corporation Commission Bureau of Financial Institutions and the Federal Reserve Board. In addition, the Bank is subject to the rules and regulations of the Federal Deposit Insurance Corporation. Deposits in the Bank are insured by the FDIC up to a maximum amount (generally $250,000 per depositor, subject to aggregation rules). The Federal Reserve Board and the Bureau of Financial Institutions regulate or monitor all areas of the Bank’s operations, including security devices and procedures, adequacy of capitalization and loss reserves, loans, investments, borrowings, deposits, mergers, issuances of securities, payment of dividends, interest rates paid on deposits, interest rates or fees charged on loans, establishment of branches, corporate reorganizations and maintenance of books and records. The Federal Reserve Board requires the Bank to maintain certain capital ratios. The Bank is required by the Federal Reserve Board to prepare quarterly reports on the Bank’s financial condition and to conduct an annual audit of its financial affairs in compliance with minimum standards and procedures prescribed by the Federal Reserve Board. The Bank also is required by the Federal Reserve Board to adopt internal control structures and procedures in order to safeguard assets and monitor and reduce risk exposure. While appropriate for safety and soundness of banks, these requirements impact banking overhead costs.

Under the provisions of federal law, federally insured banks are subject, with certain exceptions, to certain restrictions on extensions of credit to their affiliates, on investments in the stock or other securities of affiliates and on the taking of such stock or securities as collateral from any borrower. In addition, these banks are prohibited from engaging in certain tie-in arrangements in connection with any extension of credit or the providing of any property or service. The Virginia State Corporation Commission and the Federal Reserve Board conduct regular examinations of the Bank reviewing the adequacy of the loan loss reserves, quality of the loans and investments, propriety of management practices, compliance with laws and regulations and other aspects of the bank's operations. In addition to these regular examinations, Virginia chartered banks must furnish to the Federal Reserve Board quarterly reports containing detailed financial statements and schedules.

Community Reinvestment Act. The Bank is subject to the provisions of the Community Reinvestment Act of 1977 (the “CRA”), which requires the appropriate federal bank regulatory agency, in connection with its regular examination of a bank, to assess the bank's record in meeting the credit needs of the community served by the Bank, including low and moderate-income neighborhoods. The focus of the regulations is on the volume and distribution of a bank's loans, with particular emphasis on lending activity in low and moderate-income areas and to low and moderate-income persons. The regulations place substantial importance on a bank's product delivery system, particularly branch locations. The regulations require banks to comply with significant data collection requirements. The regulatory agency's assessment of the bank's record is made available to the public. Further, this assessment is required for any bank which has applied to, among other things, establish a new branch office that will accept deposits, relocate an existing office, or merge, consolidate with or acquire the assets or assume the liabilities of a federally regulated financial institution. Management expects that the Bank’s compliance with the CRA, as well as other fair lending laws, will face ongoing government scrutiny and that costs associated with compliance will continue to increase. The Bank received a "Satisfactory" CRA rating in the last examination by bank regulators.

Federal Deposit Insurance Corporation Improvement Act of 1991. The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) requires each federal banking regulatory agency to prescribe, by regulation, standards for all insured depository institutions and depository institution holding companies relating to (i) internal controls, information systems and audit systems; (ii) loan documentation; (iii) credit underwriting; (iv) interest rate exposure; (v) asset growth; (vi) compensation, fees and benefits; and (vii) such other operational and managerial standards as the agency determines to be appropriate. The compensation standards prohibit employment contracts, compensation or benefit arrangements, stock option plans, fee arrangements or other compensatory arrangements that provide excessive compensation, fees or benefits or could lead to material financial loss. In addition, each federal banking regulatory agency must prescribe by regulation standards specifying (i) a maximum ratio of classified assets to capital; (ii) minimum earnings sufficient to absorb losses without impairing capital; (iii) to the extent feasible, a minimum ratio of market value to book value for publicly traded shares of depository institutions and depository institution holding companies; and (iv) such other standards relating to asset quality, earnings and valuation as the agency determines to be appropriate. If an insured institution fails to meet any of the standards promulgated by regulation, then such institution will be required to submit a plan to its federal regulatory agency specifying the steps it will take to correct the deficiency.

Prompt corrective action measures adopted in FDICIA impose significant restrictions and requirements on depository institutions that fail to meet their minimum capital requirements. Under Section 38 of the Federal Deposit Insurance Act (the FDI Act), the federal banking regulatory agencies have developed a classification system pursuant to which all depository institutions are placed into one of five categories based on their capital levels and other supervisory criteria: well capitalized, adequately capitalized; undercapitalized; significantly undercapitalized; and critically undercapitalized.

The Bank met the requirements at December 31, 2012 to be classified as “well-capitalized.” This classification is determined solely for the purposes of applying the prompt corrective action regulations and may not constitute an accurate representation of the Bank’s overall financial condition.

If its principal federal regulator determines that an adequately capitalized institution is in an unsafe or unsound condition or is engaging in an unsafe or unsound practice, it may require the institution to submit a corrective action plan, restrict its asset growth and prohibit branching, new acquisitions and new lines of business. An institution’s principal federal regulator may deem it to be engaging in unsafe or unsound practices if it receives a less than satisfactory rating for asset quality, management, earnings or liquidity in its most recent examination.

Section 36 of FDICIA requires insured depository institutions with at least $500 million but less than $1 billion in total assets to file annual reports that must include the following:

1. Audited comparative annual financial statements.
2. The independent public accountant’s report on the audited financial statements.
3. A management report that contains a statement of management’s responsibilities for preparing the financial statement, establishing and maintaining an adequate internal control structure over financial reporting and complying with the laws and regulations designed by the FDIC and appropriate banking regulators.
4. An assessment by management of the institutions compliance with the designated laws and regulations during the year.

These amendments do not relieve public companies of their obligations to comply with the SOX Act and the SEC’s rules on internal control reporting and audit committee independence.

The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (the Interstate Act) allows bank holding companies to acquire banks in any state, without regard to state law, except that if the state has a minimum requirement for the amount of time a bank must be in existence, that law must be preserved. Under the Virginia Banking Act, a Virginia bank or all of the subsidiaries of Virginia holding companies sought to be acquired must have been in continuous operation for more than two years before the date of such proposed acquisition. The Interstate Act also permits banks to acquire out-of-state branches through interstate mergers, if the state has not opted out of interstate branching. De novo branching, where an out-of-state bank holding company sets up a new branch in another state, requires a state's specific approval. An acquisition or merger is not permitted under the Interstate Act if the bank, including its insured depository affiliates, will control more than 10% of the total amount of deposits of insured depository institutions in the United States, or will control 30% or more of the total amount of deposits of insured depository institutions in any state.

Virginia has, by statute, elected to opt-in fully to interstate branching under the Interstate Act. Under the Virginia statute, Virginia state banks may, with the approval of the Virginia State Corporation Commission, establish and maintain a de novo branch or acquire one or more branches in a state other than Virginia, either separately or as part of a merger. Procedures also are established to allow out-of-state domiciled banks to establish or acquire branches in Virginia, provided the "home" state of the bank permits Virginia banks to establish or acquire branches within its borders. The activities of these branches are subject to the same laws as Virginia domiciled banks, unless such activities are prohibited by the law of the state where the bank is organized. The Virginia State Corporation Commission has the authority to examine and supervise out-of-state state banks to ensure that the branch is operating in a safe and sound manner and in compliance with the laws of Virginia. The Virginia statute authorizes the Bureau of Financial Institutions to enter into cooperative agreements with other state and federal regulators for the examination and supervision of out-of-state banks with Virginia operations, or Virginia domiciled banks with operations in other states. Likewise, national banks, with the approval of the OCC, may branch into and out of the state of Virginia. Any Virginia branch of an out-of-state state chartered bank is subject to Virginia law (enforced by the Virginia Bureau of Financial Institutions) with respect to intrastate branching, consumer protection, fair lending and community reinvestment as if it were a branch of a Virginia bank, unless preempted by federal law.

Deposit Insurance. The Bank’s deposits are insured up to applicable limits by the Deposit Insurance Fund (DIF) of the FDIC. Pursuant to the Dodd-Frank Act, FDIC insurance coverage limits on deposits were permanently increased to $250,000. The Dodd-Frank Act also provided for unlimited FDIC insurance coverage for noninterest-bearing demand deposit accounts for a two year period beginning on December 31, 2010 and ending on December 31, 2012. The unlimited coverage for non-interest bearing demand deposit accounts was not extended past December 31, 2012.

The FDIC has adopted a risk-based assessment system to determine assessment rates to be paid by member institutions, such as the Bank. The amount of the assessment is a function of the institution’s risk category, of which there are four, and its assessment base. Under this system, risk is defined and measured using an institution’s supervisory ratings, combined with certain other risk measures, including certain financial ratios. In February 2011, the FDIC revised the risk-based assessment system to set new assessment rates that were effective on April 1, 2011. The initial base assessment rates range from 5 to 35 basis points, subject to potential adjustments based on the amount of the institution’s long-term unsecured debt and brokered deposits. After the effect of potential base-rate adjustments, the total base assessment rate could range from 2.5 to 45 basis points. As the DIF reserve ratio grows, the rate schedule will be adjusted downward. Also effective April 1, 2011, the assessment base is an institution’s average consolidated total assets less its average tangible equity.

Gramm-Leach-Bliley Act. The Gramm-Leach-Bliley Act of 1999 (the GLBA) allows banks, with primary regulator approval, to acquire financial subsidiaries to engage in any activity that is financial in nature or incidental to a financial activity, as defined in the Bank Holding Act, except (i) insurance underwriting, (ii) merchant or insurance portfolio investments, and (iii) real estate development or investment. Well-capitalized banks are also given the authority to engage in municipal bond underwriting.

To establish or acquire a financial subsidiary, a bank must be well-managed, and the consolidated assets of its financial subsidiary must not exceed the lesser of 45% of the consolidated total assets of the bank or $50 billion. The relationship between a bank and a financial subsidiary are subject to a variety of supervisory enhancements from regulators.

USA Patriot Act. The USA Patriot Act facilitates the sharing of information among government entities and financial institutions to combat terrorism and money laundering. The USA Patriot Act creates an obligation on banks to report customer activities that may involve terrorist activities or money laundering.

Government Policies. The operations of the Bank are affected not only by general economic conditions, but also by the policies of various regulatory authorities. In particular, the Federal Reserve Board regulates money and credit and interest rates in order to influence general economic conditions. These policies have a significant influence on overall growth and distribution of loans, investments and deposits and affect interest rates charged on loans or paid for time and savings deposits. Federal Reserve Board monetary policies have had a significant effect on the operating results of commercial banks in the past and are expected to continue to do so in the future.

Limits on Dividends and Other Payments. As a state member bank subject to the regulations of the Federal Reserve Board, the Bank must obtain the approval of the Federal Reserve Board for any dividend if the total of all dividends declared in any calendar year would exceed the total of its net profits, as defined by the Federal Reserve Board, for that year, combined with its retained net profits for the preceding two years. In addition, the Federal Reserve Board is authorized to determine, under certain circumstances relating to the financial condition of a state member bank, that the payment of dividends would be an unsafe or unsound practice and to prohibit payment thereof. The payment of dividends that depletes a bank's capital base could be deemed to constitute such an unsafe or unsound practice. The Federal Reserve Board has indicated that banking organizations, including bank holding companies, should generally pay dividends only out of current operating earnings.

Virginia law also imposes restrictions on the ability of the Bank to pay dividends. A Virginia state bank is permitted to declare a dividend out of its "net undivided profits", after providing for all expenses, losses, interest and taxes accrued or due by the bank. In addition, a deficit in capital originally paid in must be restored to its initial level, and no dividend can be paid which could impair the Bank's paid in capital. The Bureau of Financial Institutions further has authority to limit the payment of dividends by a Virginia bank if it determines the limitation is in the public interest and is necessary to ensure the bank's financial soundness.

The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) provides that no insured depository institution may make any capital distribution (which would include a cash dividend) if, after making the distribution, the institution would not satisfy one or more of its minimum capital requirements.

Capital Requirements. The Federal Reserve Board has adopted risk-based capital guidelines which are applicable to the Company and the Bank. The Federal Reserve Board guidelines redefine the components of capital, categorize assets into different risk classes and include certain off-balance sheet items in the calculation of risk-weighted assets. The minimum ratio of qualified total capital to risk-weighted assets (including certain off-balance sheet items, such as standby letters of credit) is 8.0%. At least half of the total capital must be comprised of Tier 1 capital for a minimum ratio of Tier 1 Capital to risk-weighted assets of 4.0%. The remainder may consist of a limited amount of subordinated debt, other preferred stock, certain other instruments and a limited amount of loan and lease loss reserves.

In addition, the Federal Reserve Board has established minimum leverage ratio (Tier 1 capital to total average assets less intangibles) guidelines that are applicable to the Company and the Bank. These guidelines provide for a minimum ratio of 4.0% for banks that meet certain specified criteria, including that they have the highest regulatory CAMELS rating and are not anticipating or experiencing significant growth and have well-diversified risk. All other banks will be required to maintain an additional cushion of at least 100 to 200 basis points, based upon their particular circumstances and risk profiles. The guidelines also provide that banks experiencing internal growth or making acquisitions will be expected to maintain strong capital positions substantially above the minimum supervisory levels, without significant reliance on intangible assets.

In summary, the capital measures used by the federal banking regulators are:

- the Total Capital ratio, which includes Tier 1 Capital and Tier 2 Capital;
- the Tier 1 Capital ratio; and
- the leverage ratio.

Under these regulations, a bank will be:

- “well capitalized” if it has a Total Capital ratio of 10% or greater, a Tier 1 Capital ratio of 6% or greater, and a leverage ratio of 5% or greater and is not subject to any written agreement, order, capital directive, or prompt corrective action directive by a federal bank regulatory agency to meet and maintain a specific capital level for any capital measure;
- “adequately capitalized” if it has a Total Capital ratio of 8% or greater, a Tier 1 Capital ratio of 4% or greater, and a leverage ratio of 4% or greater – or 3% in certain circumstances – and is not well capitalized;
- “undercapitalized” if it has a Total Capital ratio of less than 8%, a Tier 1 Capital ratio of less than 4% - or 3% in certain circumstances;
- “significantly undercapitalized” if it has a Total Capital ratio of less than 6%, a Tier 1 Capital ratio of less than 3%, or a leverage ratio of less than 3%; or
- “critically undercapitalized” if its tangible equity is equal to or less than 2% of average quarterly tangible assets.

The risk-based capital standards of the Federal Reserve explicitly identify concentrations of credit risk and the risk arising from non-traditional activities, as well as an institution’s ability to manage these risks, as important factors to be taken into account by the agency in assessing an institution’s overall capital adequacy. The capital guidelines also provide that an institution’s exposure to a decline in the economic value of its capital due to changes in interest rates be considered by the agency as a factor in evaluating a banking organization's capital adequacy.

The FDIC may take various corrective actions against any undercapitalized bank and any bank that fails to submit an acceptable capital restoration plan or fails to implement a plan accepted by the FDIC. These powers include, but are not limited to, requiring the institution to be recapitalized, prohibiting asset growth, restricting interest rates paid, requiring prior approval of capital distributions by any bank holding company that controls the institution, requiring divestiture by the institution of its subsidiaries or by the holding company of the institution itself, requiring new election of directors, and requiring the dismissal of directors and officers. The Company and the Bank presently maintain sufficient capital to remain in compliance with these capital requirements.

The Dodd-Frank Act contains a number of provisions dealing with capital adequacy of insured depository institutions and their holding companies, which may result in more stringent capital requirements. Under the Collins Amendment to the Dodd-Frank Act, federal regulators have been directed to establish minimum leverage and risk-based capital requirements for, among other entities, banks and bank holding companies on a consolidated basis. These minimum requirements cannot be less than the generally applicable leverage and risk-based capital requirements established for insured depository institutions nor quantitatively lower than the leverage and risk-based capital requirements established for insured depository institutions that were in effect as of July 21, 2010. These requirements in effect create capital level floors for bank holding companies similar to those in place currently for insured depository institutions. The Collins Amendment also excludes trust preferred securities issued after May 19, 2010 from being included in Tier 1 capital unless the issuing company is a bank holding company with less than $500 million in total assets. Trust preferred securities issued prior to that date will continue to count as Tier 1 capital for bank holding companies with less than $15 billion in total assets, and such securities will be phased out of Tier 1 capital treatment for bank holding companies with over $15 billion in total assets over a three-year period beginning in 2013. Accordingly, the Company's trust preferred securities will continue to qualify as Tier 1 capital.
In December 2010, the Basel Committee released its final framework for strengthening international capital and liquidity regulation, now officially identified by the Basel Committee as "Basel III". Basel III, when implemented by the U.S. banking agencies and fully phased-in, will require bank holding companies and their bank subsidiaries to maintain substantially more capital, with a greater emphasis on common equity.

Other Legislative and Regulatory Concerns

Other legislative and regulatory proposals regarding changes in banking and the regulation of banks, thrifts and other financial institutions are periodically considered by the executive branch of the federal government, Congress and various state governments, including Virginia. New proposals could significantly change the regulation of banks and the financial services industry. It cannot be predicted what might be proposed or adopted or how these proposals would affect the Company.

Formal Written Agreement

On October 13, 2010, the Company and Bank entered into a written agreement ("Written Agreement") with the Federal Reserve Bank of Richmond (the "Reserve Bank"). Under the terms of the Written Agreement, the Bank has agreed to develop and submit to the Reserve Bank for approval within the time periods specified therein written plans or programs to:

- strengthen board oversight of the management and operations of the Bank;
- strengthen credit risk management and administration;
- provide for the effective grading of the Bank's loan portfolio;
- summarize the findings of its review of the adequacy of the staffing of its loan review function;
- improve the Bank's position with respect to loans, relationships, or other assets in excess of $500,000 that currently are or in the future become past due more than 90 days, on the Bank's problem loan list, or adversely classified in any report of examination of the Bank;
- review and revise the Bank's methodology for determining the allowance for loan and lease losses ("ALLL") and maintain an adequate ALLL;
- maintain sufficient capital at the Company and the Bank;
- establish a revised written contingency funding plan;
- establish a revised investment policy;
- improve the Bank's earnings and overall condition;
- revise the Bank's information technology program; establish a disaster recovery and business continuity program; and,
- establish a committee to monitor compliance with all aspects of the written agreement.

Further, both the Company and the Bank have agreed to refrain from declaring or paying dividends without prior regulatory approval. The Company has agreed that it will not take any other form of payment representing a reduction in the Bank's capital or make any distributions of interest, principal or other sums on subordinated debentures or trust preferred securities without prior regulatory approval. The Company also has agreed not to incur, increase or guarantee any debt or not to purchase or redeem any shares of its stock without prior regulatory approval.

The following summarizes the Company's progress to comply with the items in the Written Agreement as of December 2012.

- A new board oversight policy has been approved and implemented;
- Completed revising the Bank's loan grading system and ALLL methodology;
- Implemented Problem Loan Action reports and Problem Asset reports for all assets over $500,000. These are reviewed with the Board and forwarded to the Federal Reserve Bank on a quarterly basis;
- Completed revising the written contingency funding plan;
- Implemented stress testing of the loan portfolio;
- Completed revising the investment policy;
- Completed a three year capital plan targeted to improve the Company's and Bank's capital levels to include strategically reducing the risk weighted assets of the Company and improvement in earnings;
- Completed a Business Continuity Plan and Disaster Recovery Plan; and,
- Formed a Directors' compliance committee to monitor the progress of each item in the written agreement. The committee meets at least quarterly and files a report with the Federal Reserve Bank.

Organization and Employment

The Company, the Bank, HCTI, HUFS and HUIS are organized in a holding company/subsidiary structure. As of December 31, 2012, the Company had no employees, except for officers, and it conducted substantially all of its operations through its subsidiaries. All cash compensation paid to the Company’s officers is paid by the subsidiary bank, including fees paid to its directors. At December 31, 2012, the Bank employed 211 full time equivalent employees at its main office, operations center, support centers and branch offices. The Company’s relationship with its employees is considered to be good. Employment has remained very stable over the last several years with very little turnover. There are no employment contracts in existence for any employee or officer.

Company Website

The Bank maintains a website at www.hubank.com. The Company makes available through the Bank’s website its annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and all amendments to those reports, free of charge, as soon as reasonably practicable after the material is electronically filed with the Securities and Exchange Commission.

Item 1A. Risk Factors

Not applicable

Item 1B. Unresolved Staff Comments

Not applicable

Item 2. Properties

The Company’s and the Bank’s headquarters are located at 340 W. Main Street, Abingdon, Virginia. In addition to the Bank's Main Office location, the Bank owns thirteen branch offices: one in the Town of Abingdon, Virginia; one in Washington County, Virginia; two in the City of Bristol, Virginia; one in the Town of Glade Spring, Virginia; one in the Town of Marion, Virginia; one in the City of Bristol, Tennessee; one in the Town of Rogersville, Tennessee; one in the Town of Boone, North Carolina; one in the Town of Banner Elk, North Carolina; two in the City of Sevierville, Tennessee; and one in the City of Knoxville, Tennessee. The Bank owns the land and buildings of all of these branch offices as well as the main office for the Company and Bank.

The Bank owns the land and two buildings used for its Collections, Human Resources, Customer Call Center, IRA Operations, Internal Audit and Facilities departments in Abingdon, Virginia as well as the land and buildings used as the Bank’s Operations Center and Technology House in Abingdon, Virginia.

The Bank owns approximately 14 acres of vacant land in Abingdon, Virginia, as well as vacant land in Bristol, Tennessee and in Washington County, Virginia and Boone, North Carolina for potential future branching.

All of the existing properties are in good operating condition and are adequate for the Company’s present and anticipated future needs.

The Bank owns all its computer and data processing hardware and is a licensee of the software it utilizes.

Item 3. Legal Proceedings

In 2010, a former borrower filed two complaints in the Circuit Court of Washington County, VA, claiming that the Bank improperly handled the repossession and disposition of collateral from a warehouse in June/July 2008. The borrower also claims that the Bank acted as its business advisor and breached fiduciary duties owed to it in this capacity. One complaint seeks $700,000 in damages for an alleged conversion based solely on the repossession/disposition of collateral. The second complaint seeks $7,850,000 in damages for an alleged breach of fiduciary duty, violation of UCC Article 9, actual fraud, unjust enrichment, and business conspiracy. In response, the Bank filed demurrers to both complaints, both of which were granted in part and denied in part with leave granted to amend. The Borrower chose not to amend either complaint, opting instead to consolidate her remaining claims into one action. The borrower's remaining claims against the Bank are for violation of UCC Article 9, fraud, unjust enrichment of personal property, and conversion of personal property. No trial date has been set. The Bank disputes the allegations and believes that they are without merit. The Bank intends to defend itself vigorously.

Item 4. Mine Safety Disclosures

Not Applicable

Part II

Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

Common Stock Information and Dividends

Trades in the Company’s common stock are reported on the Over-The-Counter Bulletin Board (OTCBB) and in the Pinksheets by at least five broker dealers under the symbol HBKA.OB. In addition, the Company maintains a list of individuals who are interested in purchasing its common stock and connects these people with shareholders who are interested in selling their stock. These parties negotiate the per share price independent of the Company. The stock transfer agent of the Company attempts to keep a record of stock sales by asking the parties about the trade price per share. Please refer to the table below entitled Common Stock Performance for a summary of sales prices known to the Company for each of the four quarters of 2012 and 2011.

Common Stock Performance – 2012

	High	Low	Quarterly Average	Dividends per Share
First Quarter	$ 1.87	$ 1.25	$ 1.53	$ -
Second Quarter	$ 2.75	$ 2.00	$ 2.37	$ -
Third Quarter	$ 2.75	$ 1.80	$ 2.19	$ -
Fourth Quarter	$ 2.75	$ 1.75	$ 1.91	$ -

Common Stock Performance – 2011

	High	Low	Quarterly Average	Dividends per Share
First Quarter	$ 4.00	$ 3.15	$ 3.29	$ -
Second Quarter	$ 3.15	$ 2.50	$ 2.94	$ -
Third Quarter	$ 2.50	$ 1.01	$ 1.51	$ -
Fourth Quarter	$ 1.50	$ 1.05	$ 1.09	$ -

The Company is currently prohibited from paying dividends without regulatory approval under the terms of the Written Agreement dated October 13, 2010. For additional information regarding regulatory restrictions on the Company's ability to pay dividends, see "Certain Regulatory Considerations - Highlands Union Bank – Limits on Dividend and Other Payments" in Item 1 above.

As of March 13, 2013, the Company had approximately 1,481 shareholders of record.

Issuer Repurchases of Equity Securities

The Company had no repurchases of common stock during the three months ended December 31, 2012. The Company does not anticipate any repurchases during 2013 in an effort to retain regulatory capital. In addition, the Company currently is prohibited from repurchasing its common stock without regulatory approval under the terms of the Written Agreement dated October 13, 2010.

The Company currently has 5,011,152 shares of common stock outstanding.
.

Item 6. Selected Financial Data

Not Applicable

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

The purpose of this discussion is to provide information about the financial condition and results of operations of the Company and its wholly-owned subsidiary and other information included in this report. This discussion should be read in conjunction with the Company's Consolidated Financial Statements and Notes to Consolidated Financial Statements.

Caution About Forward-Looking Statements

This Annual Report on Form 10-K contains 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, including certain plans, expectations, goals and projections, which are inherently subject to numerous assumptions, risks and uncertainties. The Company's actual results could differ materially from those set forth or implied in the forward-looking statements.

Such forward-looking statements involve known and unknown risks including, but not limited to, the following factors:

- Continued problems related to the national credit crisis and deepening recession;
- High unemployment continuing;
- The ability to attract and maintain capital levels adequate to support the Company's asset levels;
- Our inability to comply with the Written Agreement dated October 13, 2010;
- Our inability to comply with certain covenants of the Company's Loans with Community Bankers Bank;
- Difficult market conditions in our industry;
- Further deterioration in the housing market and collateral values;
- The ability to successfully manage the Company's strategic plan;
- Effects of the soundness of other financial institutions;
- Potential impact on us of recently enacted legislation and future regulation;
- Reliance on the Company's management team, including its ability to attract and retain key personnel;
- The successful management of interest rate risk;
- Further adverse changes in general economic and business conditions in the Company's market area;
- Changes in interest rates and interest rate policies;
- Risks inherent in making loans such as repayment risks and fluctuating collateral values;
- Competition with other banks and financial institutions, and companies outside of the banking industry, including those companies that have substantially greater access to capital and other resources;
- Demand, development and acceptance of new products and services;
- Problems with technology utilized by the Company;
- Changing trends in customer profiles and behavior; and,
- Changes in banking and other laws and regulations applicable to the Company.

Overview

At December 31, 2012, the Bank separately (on a non-consolidated basis) had total assets of $592.31 million. Total deposits at this date were $485.97 million. The Bank's net income for 2012 was $2.58 million which produced a return on average assets of 0.43% and a return on average stockholders' equity of 7.12%. Refer to Note 21 of the Notes to Consolidated Financial Statements for the Bank's risk-based capital ratios.

The Bank offers general retail and commercial banking services to individuals, businesses and local government units. These products and services include accepting deposits in the form of checking accounts, money market deposit accounts, interest-bearing demand deposit accounts, savings accounts and time deposits; making real estate, commercial, revolving, consumer, credit card and agricultural loans; offering letters of credit; providing other consumer financial services, such as automatic funds transfer, collections, night depository, safe deposit, travelers checks and savings bond sales; and providing other miscellaneous services normally offered by commercial banks.

The Company makes money primarily by earning an interest rate spread between the interest rates it earns on loans and securities and interest rates it pays on deposits and other borrowed money. The Company also earns money through fees, service charges and other non-interest income.

Critical Accounting Policies

General

The financial condition and results of operations presented in the Consolidated Financial Statements, accompanying Notes to Consolidated Financial Statements and management's discussion and analysis are, to a large degree, dependent upon the accounting policies of the Company. The selection and application of these accounting policies involve judgments, estimates, and uncertainties that are susceptible to change.

Presented below is a discussion of the Accounting Policies that management believes are important to the understanding of the Company's financial condition and results of operations. These critical accounting policies require management's most difficult, subjective and complex judgments about matters that are inherently uncertain. In the event that different assumptions or conditions were to prevail, and depending upon the severity of such changes, the possibility of materially different financial condition or results of operations is a reasonable likelihood. See also Note 1 of the Notes to Consolidated Financial Statements.

Allowance for Loan Losses

The Company monitors and maintains an allowance for loan losses to absorb the estimate of probable losses inherent in the loan portfolio. The allowance for loan losses is based on management's judgment and analysis of current and historical loss experience, risk characteristics of the loan portfolio, concentrations of credit and asset quality, as well as other internal and external factors, such as general economic conditions. The Company recognizes the inherent imprecision in estimates of losses due to various uncertainties, and variability related to the factors used. If different assumptions or conditions were to prevail and it is determined that the allowance is not adequate to absorb the new estimate of probable losses, an additional provision for loan losses would be made, which amount may be material to the Consolidated Financial Statements.

Other than Temporary Impairment

On a quarterly basis the Company reviews any securities which are considered to be impaired as defined by accounting guidance. During this review, the Company determines if the impairment is deemed to be other than temporary. If it is determined that the impairment is other than temporary, i.e. impaired because of credit issues, the investment is written down through the Statement of Income in accordance with accounting guidance. See Footnote 3 in the Notes to Consolidated Financial Statements for a discussion of the various inputs used as it pertains to the determination of other than temporary impairment.

Performance Summary

The following table shows the Company's key performance ratios for the years ended December 31, 2012 and 2011:

	2012	2011
Return on Average Assets	0.34 %	(1.02 %)
Return on Average Equity	6.82 %	(20.52 %)
Basic Earnings (Loss) Per Share	$ 0.40	(1.30)
Fully Diluted Earnings (Loss) per share	$ 0.40	(1.30)
Net Interest Margin (1)	3.44 %	3.15 %
Average Equity to Average Assets Ratio	4.92 %	4.97 %

(1) Net Interest Margin - Year-to-date tax equivalent net interest income divided by year-to-date average earning assets

Balance Sheet Summary

The following table shows the Company's key balance sheet indicators at December 31, 2012 and 2011:
(dollar amounts in thousands)

	12/31/12	12/31/11
Securities	$ 57,400	$ 64,252
Loans, net	$ 383,049	$ 398,780
Deposits	$ 485,340	$ 515,361
Assets	$ 592,496	$ 620,983

Asset Quality

The following table shows the Company’s key asset quality indicators at December 31, 2012 and 2011:

(dollar amounts in thousands)

	12/31/12	12/31/11
Non-accrual loans	$ 10,544	$ 19,345
Loans past due over 90 days and still accruing interest	6	1,450
Other real estate owned, net	16,639	16,724
Allowance for loan losses to total loans	1.91 %	2.21 %
Net charge-off ratio	0.63 %	1.39 %

For further information see the discussion under "Provision and Allowance for Loan Losses" below.

Results of Operations

Net Interest Income
(dollar amounts in thousands)

Net interest income for 2012 was $17,666 or an increase of $491 from 2011. During 2012 interest income decreased by $2,000. This was a result of a reduction in interest earning assets, existing interest earning assets re-pricing at lower rates, and new loans made and securities purchased with lower yields. Average interest earning assets decreased approximately $36,874 from 2011. Interest-bearing liabilities also re-priced downward, causing a decrease in interest expense of $2,491. The net result of these changes was an increase in the Company’s net interest margin to 3.44% in 2012 from 3.15% in 2011. During 2011 and 2012, the Federal Reserve Board continued to leave rates at historical lows. The federal funds rate remained at a range below .25% as the economy showed only minimal signs of recovery during the year.

The tax equivalent yield on earning assets for 2012 was 4.88%, decreasing 5 basis points as compared to 2011. During the same period, the yield on interest bearing liabilities was 1.60%, which was a decrease of 36 basis points. Average interest bearing liabilities decreased $43,522 from 2011. The Company continued to lower time deposit rates throughout the year in an effort to reduce its cost of funds as well as to reduce total assets. The reduction in both the volume and average rates on interest earning assets was partially offset by the reduction in rates paid on interest bearing deposits, primarily time deposits. The Company also re-structured $47,500 of its FHLB borrowings during the third quarter of 2012. (See Note 10 of the Notes to Consolidated Financial Statements).

Analysis of Net Interest Earnings

The following table shows the major categories of interest-earning assets and interest-bearing liabilities, the interest earned or paid, the average yield or rate on the average balance outstanding, net interest income and net yield on average interest-earning assets and average interest spread for the years indicated.

	Year Ended December 31,								
	2012			2011			2010		
(Dollars in Thousands)	Average Balance	Interest Income/ Expense	Yield/ Rate	Average Balance	Interest Income/ Expense	Yield/ Rate	Average Balance	Interest Income/ Expense	Yield/ Rate
ASSETS									
Interest earning assets (taxable-equivalent basis):									
Loans (net of unearned discount (1)	$400,361	$23,337	5.83 %	$428,811	$24,842	5.79 %	$479,367	$28,140	5.87 %
Securities (2)(3)	63,830	1,676	3.17	67,667	2,162	3.89	71,565	2,658	4.95
Federal funds sold	58,877	141	0.24	63,466	150	0.24	26,300	60	0.23
Total interest-earning assets	$523,068	$ 25,154	4.88 %	$559,944	$ 27,154	4.93 %	$577,232	$ 30,858	5.50 %
LIABILITIES									
Interest bearing liabilities:									
Interest bearing deposits	$392,154	$4,229	1.08 %	$433,481	$6,495	1.50 %	$440,737	$8,859	2.01 %
Other interest bearing liabilities	74,709	3,259	4.36	76,904	3,484	4.53	84,729	3,679	4.34
Total interest-bearing liabilities	$466,863	$ 7,488	1.60 %	$510,385	$ 9,979	1.96 %	$525,466	$ 12,538	2.39 %
Net interest income		$17,666			$17,175			$18,320	
Net margin on interest earning assets on a tax equivalent basis			3.44 %			3.15 %			3.33 %
Average interest spread			3.28 %			2.97 %			3.11 %

(1) For the purposes of these computations, non-accruing loans are included in the daily average loan amounts outstanding.
(2) Tax equivalent adjustments (using 34% federal tax rates) have been made in calculating yields on tax-free investments. Virginia banks are exempt from state income tax.

(3) The yield on securities classified as available for sale is computed based on the average balance of the historical amortized cost balance without the effects of the fair value adjustment required by ASC 320.

Analysis of Changes in Interest Income and Interest Expense

The Company's primary source of revenue is net interest income, which is the difference between the interest and fees earned on loans and investments and the interest paid on deposits and other funds. The Company's net interest income is affected by changes in the amount and mix of interest-earning assets and interest-bearing liabilities and by changes in yields earned on interest-earning assets and rates paid on interest-bearing liabilities. The following table sets forth, for the years indicated, a summary of the changes in interest income and interest expense resulting from changes in average asset and liability balances (volume) and changes in average interest rates (rate). The increases (decrease) due to change in volume is computed using the change in the average balances between 2012 and 2011 and 2011 and 2010 multiplied by the corresponding current year average rates. The remaining increase or decrease in net interest income is allocated to the change in rate.

Increase/(Decrease) Due to Volume and Rate

	2012 Compared to 2011		
Increase (Decrease) in	Increase (decrease) due to change in volume	Increase (decrease) due to change in rate	Net increase (decrease)
	(Dollars in Thousands)		
INTEREST INCOME			
Securities	$ (122)	$ (364)	$(486)
Federal funds sold	(11)	2	(9)
Loans	(1,658)	153	(1,505)
Total Income Change	$(1,791)	$(209)	$(2,000)
INTEREST EXPENSE			
Savings and time deposits	$ (445)	$ (1,821)	$(2,266)
Other interest-bearing liabilities	(96)	(129)	(225)
Total Expense Change	$(541)	$(1,950)	$(2,491)
Increase (Decrease) in Net Interest Income	$(1,250)	$ 1,741	$ 491

	2011 Compared to 2010		
Increase (Decrease) in	Increase (decrease) due to change in volume	Increase (decrease) due to change in rate	Net increase (decrease)
	(Dollars in Thousands)		
INTEREST INCOME			
Securities	$ (152)	$ (344)	$(496)
Federal funds sold	88	3	91
Loans	(2,929)	(369)	(3,298)
Total Income Change	$(2,993)	$(710)	$(3,703)
INTEREST EXPENSE			
Savings and time deposits	$ (108)	$ (2,255)	$(2,363)
Other interest-bearing liabilities	(355)	160	(195)
Total Expense Change	$(463)	$(2,095)	$(2,558)
Increase (Decrease) in Net Interest Income	$(2530)	$ 1,385	$(1,145)

Non-interest Income
(dollar amounts in thousands)

Non-interest income for 2012 included an “other-than-temporary-impairment charge” (“OTTI”) in the amount of $167. In 2011, the Company incurred a $269 charge for OTTI. Both amounts pertain to write-downs on our trust preferred securities issued primarily by banks and a limited number of insurance companies and real estate investment trusts. The cash flow projections for the pooled trust preferred securities is based on a discounted cash flow model that uses variables such as the estimate of future cash flows, creditworthiness of the underlying banks and determination of probability of default of the underlying collateral. Cash flows are constructed in an INTEX cash flow model. It includes each individual issue's structural features updated with trustee information, including asset-by-asset detail as it becomes available. The modeled cash flows are then used to determine if all the scheduled principal and interest payments of our investments will be made.

The expected future default assumptions for the pooled trust preferred securities are based upon the Company's best estimate of future deferrals. Banks currently in default or deferring interest payments are assigned a 100% probability of default. In all cases, a 15% projected recovery rate is applied to current and projected deferrals. No OTTI was incurred during the last 9 months of 2012 as the number of cures and redemptions by the underlying banks increased and the number of new deferrals decreased significantly as compared to the previous two-year period.

The Company's non-interest income increased by $363 from 2011 to 2012. Service charges on deposit accounts (primarily overdraft fees) decreased $25 as compared to 2011. The number of checks processed continues to decline as the number of electronic transactions increases. Debit card fee income increased by $91 over 2011 due to increases in Visa check card volumes. The use of debit cards continues to increase significantly each year.

Earnings related to the Company's holdings of Bank Owned Life Insurance totaled $459 and $452 for 2012 and 2011, respectively.

Non-interest Expense
(dollar amounts in thousands)

Non-interest expense is comprised of salaries and employee benefit costs, occupancy expenses, furniture and equipment expenses and other operating expenses. Non-interest expense for 2012 was $19,684, a decrease of $1,853 from 2011. Salaries and employee benefits decreased by 3.54% or $349 as the Company continued to reduce staffing levels. Technology enhancements have allowed the Bank to leverage its existing personnel base to help control personnel costs. FDIC premiums totaled $1,330 compared to $1,539 in 2011. OREO (other real estate owned) write-downs and OREO expenses totaled $2,190 in 2012 compared to $3,328 in 2011. Depressed real estate values has made the selling of foreclosed properties very challenging even after significantly lowering asking prices. Additionally, surpluses of foreclosed and other properties in the Company's market areas have affected sales of OREO properties. Nevertheless, the Company has seen an improvement in the ability to sell OREO properties during the past year.

Income Taxes
(dollar amounts in thousands)

Income taxes in 2012 totaled $220 compared to $2,362 in 2011. The 2011 total includes a $4,170 deferred tax valuation allowance. Deferred tax assets represent the future tax benefit of deductible differences and, if it is more likely than not that a tax asset will not be realized, a valuation allowance is required to reduce the recorded deferred tax assets to net realizable value. As of December 31, 2011, in consideration of uncertainties regarding the timing of improvements in current economic conditions and management's estimate of future tax liabilities, management provided an allowance of $4,170 to reflect its estimate of net realizable value at that date. As of December 31, 2012, management maintained an allowance of $4 million to reflect its estimate of net realizable value at that date. A valuation allowance will be maintained until the Company determines that it is more probable than not that all of the deferred tax assets will be realized. That determination, among other things, will be based on a pattern of consistent quarter over quarter earnings performance.

27

Provision and Allowance for Loan Losses
(dollar amounts in thousands)

The adequacy of the allowance for loan losses is based on management's judgment and analysis of current and historical loss experience, risk characteristics of the loan portfolio, concentrations of credit and asset quality, as well as other internal and external factors, such as general economic conditions. The internal credit review department performs pre-approval analyses of large credits and also conducts credit review activities that provide management with an early warning of loan deterioration. The senior credit administration officer prepares quarterly analyses of the adequacy of the allowance for loans losses. These analyses include individual loans considered impaired for direct exposure. In addition, potential losses on loan pools and pool allocations are based upon historical losses and other factors, as adjusted, for various loan types. Prior to the economic downturn, the Company used a straight rolling three-year history by loan category in determining pool allocation factors. However, in response to the elevated level of losses in recent years and the continuing decline in real estate values, the Company modified its pool allocations as of December 31, 2012 and 2011 to apply more weighting to the rates of losses incurred during the more recent periods rather than the average of the prior three years. In addition to the change in the period of historical losses included in the calculation, additional amounts were allocated based upon internal and external factors such as changing trends in the loan mix, the effects of changes in business conditions in our market areas, unemployment trends, the effects of any changes in loan policies, competition, regulatory factors, and environmental factors related to our loan portfolio. The calculation for allowance for loan losses is reviewed by both the Credit Administration Committee and the Board of Directors. There can be no assurance however that additional provisions for loan losses will not be required in the future as a result of adverse changes in the economy, or further decreases in real estate values which will affect management’s future assumptions and allowance methodology.

The Company’s allowance for loan losses to total loans was 1.91% and 2.21%, respectively at December 31, 2012 and December 31, 2011.

At December 31, 2012 and 2011, the internal credit review department as well as management determined that the Company's allowance for loan losses is sufficient and is appropriate based on the requirements of US generally accepted accounting principles.

The following table presents the Company's loan loss experience for the past five years:

	Years Ended December 31, (Dollars in Thousands)				
	2012	2011	2010	2009	2008
Allowance for loan losses at beginning of year	$9,024	$10,320	$11,681	$5,171	$4,630
Loans charged off:					
Residential 1-4 Family	584	971	907	119	98
Multifamily	246	246	258	-	-
Construction and Land Loans	518	1.857	1.747	-	19
Commercial, Owner Occupied	686	517	746	1,013	106
Commercial, Non-owner occupied	183	276	46	40	-
Second Mortgages	90	351	485	-	61
Equity Lines of Credit	23	25	81	84	-
Farmland	4	272	131	403	-
Secured (other) and unsecured					
Personal	300	412	556	670	606
Commercial	592	934	1,056	698	195
Agricultural	2	98	24	-	16
Overdrafts	153	173	207	220	215
Total	3,381	6,132	6,244	3,247	1,316
Recoveries of loans previously charged off:					
Residential 1-4 Family	161	19	1	-	-
Multifamily	-	-	-	-	-
Construction and Land Loans	453	53	-	-	-
Commercial, Owner Occupied	5	-	3	-	1
Commercial, Non-owner occupied	2	-	-	-	-
Second Mortgages	3	10	-	1	-
Equity Lines of Credit	-	-	1	-	-
Farmland	2	20	-	-	-
Secured (other) and unsecured					
Personal	74	69	54	114	144
Commercial	144	16	19	12	122
Agricultural	4	1	3	16	-
Overdrafts	-	-	3	-	-
Total	848	188	84	143	267
Net loans charged off	2,533	5,944	6,160	3,104	1,049
Provision for loan losses	958	4,648	4,799	9,614	1,590
Allowance for loan losses end of year	$7,449	$9,024	$10,320	$11,681	$5,171
Average total loans (net of deferred fees)	$400,361	$428,811	$479,367	$490,481	$477,027
	$390,498	$407,804	$450,594	$486,119	$490,425

Total loans (net of deferred fees) at year-end					
Ratio of net charge-offs to average loans	0.63 %	1.39 %	1.28 %	0.63 %	0.22 %
Ratio of provision for loan losses to average loans	0.24 %	1.08 %	1.00 %	1.96 %	0.33 %
Ratio of provision for loan losses to net charge-off	37.82 %	78.20 %	77.91 %	309.72 %	151.57 %
Allowance for loan losses to year-end loans	1.91 %	2.21 %	2.29 %	2.40 %	1.05 %

Non-performing loans
(dollar amounts in thousands)

The loan portfolio of the Bank is reviewed regularly by both senior officers and the credit review department to monitor loan performance. The frequency of the review is based on the size of the loan relationship, performance, the rating of credit worthiness of the borrower utilizing various factors such as net worth, credit history and customer relationship. The evaluations emphasize different factors depending upon the type of loan involved. Commercial and real estate loans are reviewed on the basis of projections of cash flow and estimated net realizable value through an evaluation of collateral and the financial strength of the borrower. Installment loans are evaluated largely on the basis of delinquency data because of the large number of such loans and relatively small size of each individual loan.

Management's review of commercial and other loans may result in a determination that a loan should be placed on non-accrual. It is the policy of the Bank to discontinue the accrual of interest on any loan on which full repayment of principal and / or interest is doubtful. Subsequent collection of interest is recognized as income on a cash basis upon receipt. Placing a loan on non-accrual status for the purpose of income recognition is not in itself a reliable indication of potential loss of principal. Other factors, such as the value of the collateral securing the loan and the financial condition of the borrower serve as more reliable indicators of potential loss of principal.
The policy of the Bank is that non-performing loans consist of loans accounted for on a non-accrual basis and loans which are contractually past due 90 days or more in regards to interest and/or principal payments. The following table presents non-performing loans at December 31.

	2012	2011	2010	2009	2008
			(Amounts in thousands)		
Non-performing loans	$10,550	$20,795	$18,881	$15,819	$6,934
Non-accrual loans	$10,544	$19,345	$14,353	$11,559	$6,278
Loans past-due 90 days and more and still accruing	$6	$1,450	$4,528	$4,260	$656
Interest income lost on non-accruing loans	$725	$1,187	$925	$497	$417

The Company has seen the greatest deterioration of its commercial real estate loan portfolio in the Sevierville, Tennessee market area and North Carolina market areas.

Due to the significant increase in non-performing loans the Company significantly increased its loan loss provisions from 2009 to 2011 as compared to previous years. The allowance for loan losses to total loans decreased from 2.21% to 1.91% during 2012. This was primarily due to reduced provisions and to loans being transferred into OREO and/or liquidated and subsequently written down to current market values out of specific reserves allocated to such loans. It is management's opinion that at December 31, 2012, the allowance for loan losses was determined to be in accordance with US generally accepted accounting principles and is adequate. The allowance for loan losses is reviewed and approved quarterly by the Board of Directors.

Allocation of the allowance for loan losses

The following table provides an allocation of the allowance for loan losses at December 31, 2012, 2011, 2010, 2009 and 2008.

	December 31, Percent of Loans on each Category (Dollars in Thousands)								
	2012			2011			2010		
	Allowance for Loan Loss	Percentage of Total Allowance	Percentage of Total Loans	Allowance for Loan Loss	Percentage of Total Allowance	Percentage of Total Loans	Allowance for Loan Loss	Percentage of Total Allowance	Percentage of Total Loans
Residential 1-4 Family	$ 1,242	16.67 %	42.90 %	$ 1,618	17.93 %	41.39 %	$ 1,521	14.74 %	38.91 %
Multifamily	280	3.76	4.44	477	5.29	3.77	229	2.22	3.46
Construction and Land Loans	823	11.05	4.90	1,746	19.35	5.70	2,155	20.88	6.85
Commercial – Owner Occupied	1,039	13.95	16.50	1,209	13.40	17.48	504	4.88	17..35
Commercial Non Owner Occupied	1,075	14.43	9.09	400	4.43	8.94	1,353	13.11	9.67
Second Mortgages	161	2.16	2.38	371	4.11	3.00	323	3.13	3.13
Equity Line of Credit	30	0.40	2.12	69	0.76	2.23	83	.80	2.22
Farmland	97	1.30	2.86	336	3.72	2.99	229	2.22	2.83
Personal	486	6.53	5.72	764	8.47	5.83	516	5.00	5.93
Commercial	1,530	20.54	8.15	1,620	17.95	7.94	2,119	20.53	8.97
Agricultural	-	-	.86	-	-	.68	66	.64	0.63
Overdrafts	-	-	0.08	-	-	0.05	-	0.00	.05
Unallocated	686	9.21	-	414	4.59	-	1,222	11.85	-
Total	$ 7,449	100.00 %	100.00 %	$ 9,024	100.00 %	100.00 %	$ 10,320	100.00 %	100.00 %

December 31,
Percent of Loans on each Category

(Dollars in Thousands)

	2009			2008		
	Allowance for Loan Loss	Percentage of Total Allowance	Percentage of Total Loans	Allowance for Loan Loss	Percentage of Total Allowance	Percentage of Total Loans
Residential 1-4 Family	$384	3.29 %	37.80 %	$330	6.38 %	35.89 %
Multifamily	184	1.57	2.65	190	3.68	2.67
Construction and Land Loans	2,113	18.09	9.64	958	18.53	13.42
Commercial – Owner Occupied	3.863	33.07	17.63	851	16.46	16.49
Commercial Non Owner Occupied	1,846	15.81	8.43	470	9.09	6.59
Second Mortgages	300	2.57	3.49	269	5.20	3.77
Equity Line of Credit	242	2.07	2.09	145	2.80	2.03
Farmland	503	4.31	2.30	138	2.67	1.93
Personal	918	7.86	6.10	408	7.89	6.28
Commercial	814	6.97	9.21	262	5.07	9.82
Agricultural	-	-	0.63	74	1.43	1.06
Overdrafts	15	0.12	0.04	23	0.44	0.05
Unallocated	499	4.27	-	1,053	20.35	-
Total	$11,681	100.00 %	100.00 %	$5,171	100.00 %	100.00 %

Financial Condition

Balance Sheet
(dollar amounts in thousands)

Total assets of the Company decreased by $28,487 or 4.59% in 2012. Average interest earning assets decreased approximately $36,874 from 2011. The Company has made a concerted effort to reduce its higher risk weighted assets to improve the Company's and the Bank's regulatory capital ratios. Average interest bearing liabilities, primarily time deposits, decreased by $43,522 from 2011. Total deposits decreased $30,021 as the Company continued to lower its offering rates on time deposits in an effort to decrease its cost of funds.

Loans
(dollar amounts in thousands)

Loans net of unearned income and deferred fees decreased by $17,306 or 4.24% in 2012. Loan demand has continued to be weak. The Company has also implemented a plan to reduce higher risk weighted assets, primarily commercial real estate loans and other commercial loans.

Prior to the economic downturn, the Company's portfolio of commercial, construction and land development loans had experienced significant growth. During the last three years, the Company has made a concerted effort to reduce its commercial real estate, construction and land loans as these types of loans provide the greatest risk of loss due to declining real estate values in many of the markets served by the Bank. This segment of loans decreased by $11,950 or 9.11% during 2012. As construction and commercial lending has slowed significantly in the last three years, a diligent effort has been made to concentrate on permanent financing for residential mortgages.

The Company has also implemented a separate credit analysis department to review larger loan requests, typically loan requests in excess of $250,000. This department operates separately from the loan origination arm of the Bank and completes independent and unbiased reviews of each new loan request. The senior officer of this department meets monthly with the Loan Committee of the Board of Directors.

Loan Portfolio

The table below classifies gross loans by major category and percentage distribution at December 31, for each of the past five years:

	December 31, (Dollars in thousands)									
	2012		2011		2010		2009		2008	
	Amount	Percentage	Amount	Percentage	Amount	Percentage	Amount	Percentage	Amount	Perce
Real Estate Secured:										
Residential 1-4 family	$167,777	42.90 %	$169,027	41.39 %	$175,522	38.90 %	$183,983	37.80 %	$176,239	35.8
Multi-family	17,348	4.44	15,375	3.77	15,593	3.46	12,895	2.65	13,114	2.67
Construction and Land Loans	19,161	4.90	23,295	5.70	30,901	6.85	46,929	9.64	65,992	13.4
Commercial, Owner Occ.	64,504	16.50	71,367	17.48	78,279	17.35	85,791	17.63	80,987	16.4
Commercial, Non Owner Occupied	35,536	9.09	36,489	8.94	43,652	9.67	41.032	8.43	32,360	6.59
Second Mortgages	9,298	2.38	12,247	3.00	14,132	3.13	16,980	3.48	18,449	3.77
Equity Lines of Credit	8,287	2.12	9,126	2.23	10,016	2.22	10,164	2.09	9.984	2.03
Farmland	11,180	2.86	12,207	2.99	12,790	2.83	11,176	2.30	9,501	1.93
	$333,091	85.19 %	$349,133	85.50 %	$380,885	84.41 %	$408,950	84.02 %	$406,676	82.8
Secured, Other and Unsecured										
Personal	$22,358	5.72 %	$23,824	5.83 %	$26,773	5.94 %	$29,703	6.10 %	$30,843	6.28
Commercial	31,927	8.15	32,407	7.94	40,471	8.97	44,840	9.21	48,230	9.82
Agricultural	3,372	0.86	2,784	0.68	2,848	0.63	3,069	0.63	5,076	1.04
	$57,657	14.73 %	$59,015	14.45 %	$70,092	15.54 %	$77,612	15.94 %	$84,149	17.1
Overdrafts	$297	0.08 %	$207	0.05 %	$214	0.05 %	$191	0.04 %	$246	0.05
Loans, gross	$391,045	100.00 %	$408,355	100.00 %	$451,191	100.00 %	$486,753	100.00 %	$491,071	100.

The following table shows the maturity of loans outstanding, inclusive of expected prepayments and contractual amortization, at December 31, 2012: (Non accrual loan balances are reflected in the immediate time period)

	December 31, 2012 (Amounts in Thousands)						
	Within One Year		After One Year But Within Five Years		After Five Years		
	Fixed	Floating	Fixed	Floating	Fixed	Floating	Total
Real Estate Secured:							
Residential 1-4 Family	$46,931	$16,096	$45,523	$40,874	$-	$14,108	$163,532
Multi-family	2,761	275	13,502	526	-	280	17,344
Construction and Land Loans	6,273	1,669	7,914	657	978	753	18,244
Commercial , Owner Occupied	15,800	5,264	30,716	2,722	4,296	3,117	61,915
Commercial, Non-Owner Occupied	8,726	2,900	16,922	1,499	2,232	1,717	33,996
Second Mortgages	3,783	605	3,831	618	-	215	9,052
Equity Line of Credit	-	1,991	-	5,495	-	801	8,287
Farmland	4,128	1,377	4,585	455	-	635	11,180
Secured, Other and Unsecured					-		
Personal	7,379	4,432	8,067	1,874	-	606	22,358
Commercial	10,389	5,439	15,115	237	-	11	31,191
Agricultural	1,097	570	1,412	25	-	1	3,105
Overdrafts	297	-	-	-	-	-	297
Non Accrual Loans	10,544	-	-	-	-	-	10,544
Loans, Gross	$118,108	$40,618	$147,587	$ 54,982	$ 7,506	$ 22,244	$ 391,045

Foreclosed Assets (Other Real Estate Owned)
(dollar amounts in thousands)

At December, 2012 OREO balances were $17,139 and consisted of 54 relationships. At December, 2011 OREO balances were $17,224 and consisted of 50 relationships. The following chart details each category type, number of relationships and balance.

OREO Property at 12/31/2012

OREO Description	Number	Balance at 12/31/12 (in thousands)
Land Development - Vacant Land	21	$ 4,208
1-4 Family	17	4,593
Multifamily	2	2,718
Commercial Real Estate	14	5,620
Total	54	$ 17,139

OREO Property at 12/31/2011

OREO Description	Number	Balance at 12/31/11 (in thousands)
Land Development - Vacant Land	17	$ 4,375
1-4 Family	23	6,248
Multifamily	1	2,635
Commercial Real Estate	9	3,966
Total	50	$ 17,224

The following table shows the activity related to OREO for the periods ended December 31, 2012 and 2011.

OREO Description	2012	2011
Beginning balance, January 1	$ 17,224	$ 15,316
Additions	8,629	8,021
Deletions	8,714	6,113
Ending Balance, December 31	$ 17,139	$ 17,224

One multifamily property, totaling $2,028, located outside the Sevierville, Tennessee area. contains twenty – six residential units. Another large relationship totals $1,823 and is a tract of land of partially developed lots and four completed condos also in the Sevierville, Tennessee market area. There has been greater deterioration in the Tennessee commercial real estate market compared to many other markets we serve. The Bank is actively marketing all of its property through its website, listing agents, and other marketing methods.

The Company formed a special assets committee to focus directly on selling OREO properties and reducing other non-performing assets. The committee is comprised of lending officers from all of the Bank's three market areas. The ability to sell OREO which has been negatively affected by the current economic climate and the resulting reduction of non-performing assets, will to a large degree, depend on how quickly specific market areas rebound from the recession.

For the years ended December 31, 2012 and 2011, the Company also accrued a $500 general valuation reserve due to the current real estate market conditions and in the expectation of receiving and accepting offers in the coming months that are lower than current appraised values. This has been the experience in recent months. Management has allocated significant resources to facilitate sales of OREO to reduce the Company's non-performing assets.

Securities
(dollar amounts in thousands)

Investment securities available for sale decreased $6,852 (market value) from December 31, 2011 to December 31, 2012. The Company made only a limited number of purchases during 2012 primarily due to the possible need for "on-balance" sheet liquidity and because of the current low investment yields available.

Yields on typical investment securities continued to be very low during 2012. Purchases during the year consisted primarily of fixed rate Government National Mortgage Association ("GNMA") mortgage backed securities and SBA pools, both of which have the full faith and credit of the US government and also carry a zero risk weighting. During the year, management continued its investment strategy to purchase securities that will blend in with the Company's overall asset liability strategy, contain zero risk weighting and also maximize yield. The majority of the recent pay downs were contractual amortization and prepayments on variable rate securities as a result of prepayments occurring on the underlying mortgages. The Company also sold approximately $11,557 of GNMAs, Municpals and SBAs during the year realizing gains of approximately $663.

The segment of our portfolio that contains the largest unrealized loss is our pooled trust preferred securities (TRUP CDOs) which represent trust preferred securities issued primarily by banks and a limited number of insurance companies and real estate investment trusts. As of December 31, 2012, our TRUP CDOs amortized cost totaled $3,879.

During 2012, we incurred credit-related OTTI charges on our TRUP CDOs of $167. For the year ended December 31, 2011, we incurred credit-related OTTI charges on our TRUP CDOs of $269. The Company continues to review its investment portfolio on a quarterly basis for indications of other-than-temporary impairment ("OTTI"). See Footnote 3 in the Notes to the Financial Statements for a detailed discussion of the Company's OTTI analysis.

Investment Portfolio

The following table presents the maturity distribution, market value, amortized cost and approximate tax equivalent yield (assuming a 34% federal income tax rate) of the investment portfolio at December 31, 2012.

(Dollars in Thousands)	Within One Year	One Year Through Five Years	Five Years Through Ten Years	After Ten Years	Yield	Market Value	Amortized Cost
Mortgage-backed Sec – fixed rate	$ 4	$ 10	$ -	$ 24,446	2.10 %	$ 24,460	$ 23,991
Mtg.-backed Sec – variable rate	-	-	53	3,129	2.34	3,182	3,129
State & Municipal's – tax exempt	-	-	525	9,807	6.35	10,332	10,066
State & Municipal's – taxable	-	-	1,653	-	3.15	1,653	1,642
Pooled Trust Preferred	-	-	-	294	0.00	294	3,879
Single Issue Trust Preferred	-	-	-	886	6.84	886	908
SBA bonds – fixed rate			2,664	13,402	2.00	16,066	16,094
SBA bonds – variable rate	-	-	-	25	0.82	25	25
SLMA	-	502	-		3.50	502	500
TOTAL	4	$ 512	$ 4,895	$ 51,989		$ 57,400	$ 60,234
Total fixed rate securities	$ 4	$ 10	$ 4,842	$ 48,541		$ 53,397	$ 52,701
Total variable rate securities	$ -	$ 502	$ 53	$ 3,448		$ 4,003	$ 7,533

Mortgage backed securities / CMOs- All of the MBS / CMOs listed above are agency (FHLMC, FNMA, GNMA) issues. The Company does not hold any non-agency mortgage backed securities.

State and Municipals - A breakdown of the Company's municipal bond portfolio is shown in the following table segregated by credit rating (Moody's or S & P).

Credit Rating	Fair Value	Amortized Cost
AA+	$ 1,653	$ 1,642
AA-	$ 4,156	$ 4,033
Aa2	$ 812	$ 777
Aa3	$ 587	$ 552
A+	$ 319	$ 305
A1	$ 243	$ 242
Baa2	$ 253	$ 253
BBB+	$ 105	$ 89
BBB	$ 414	$ 406

NR	$ 3,443	$ 3,409
TOTAL	$ 11,985	$ 11,708

All of the above non-rated securities were rated investment grade when purchased by the Company. Due to the financial crisis, a significant number of municipal bonds are no longer rated by the various rating agencies, even though they do have underlying credit support. All except two of the underlying issuers (municipalities) of the non-rated munis above totaling $3.41 million have had subsequent parity issues that have been rated investment grade. The Company performs periodic credit reviews on any non-rated munis that additionally have not had a subsequent parity issued currently rated “investment grade.”

Pooled Trust Preferred Securities - See discussion above and Footnote 3 in the Notes to the Financial Statements for further information concerning the Company’s pooled trust preferred securities.

Single Issue Trust Preferred - All of the single issue trust preferred securities held by the Bank are issued by large regional or national banks that are well capitalized institutions. The Company reviews the filings of these institutions on a quarterly basis.

SBA Pools - All of the SBA pools owned by the Company have the full faith and credit of the US government and carry a zero risk weighting.

	Fair Value	Amortized Cost
Pooled Trust Preferred Securities (TRUPS) –(rated below investment grade)	$ 294	$ 3,879
Single Issue Trust Preferred	886	908
SLMA (rated BBB)	502	500
SBA Pools	16,091	16,119

Deposits / Funding
(dollar amounts in thousands)

Total deposits decreased by $30,021 or 5.83% in 2012. Non-interest bearing demand deposits increased by $7,010. Interest bearing demand deposits increased by $4,864. Total time deposits decreased by $51,033. Savings accounts increased by $9,138 during the year. The decrease in time deposits is primarily a result of the Company's actions to reduce its higher cost CD's in an effort to lower its overall cost of funds. The average rate paid on time deposits during 2012 decreased 46 basis points compared to the prior year. The Company has experienced a significant increase in demand deposits. The Company over the years has used its alternative funding sources (primarily FHLB advances) to help facilitate growth. As of December 31, 2012, the Company had $67,900 of FHLB borrowings. The Company secures the FHLB advances with a selected group of residential mortgage loans and commercial real estate loans as well as a specific group of securities available for sale. During the third quarter of 2012, the Bank restructured $47,500 of its $67,900 of FHLB borrowings. This restructuring resulted in a decrease in the weighted average borrowing rate by approximately 100 basis points or approximately $480,000 in reduced interest expense annually. It also extended the average maturity dates on these borrowings by approximately 2.5 years.

The following table provides a breakdown of deposits at December 31 as indicated:

	December 31, (Dollars in Thousands)	
	2012	2011
Non-interest bearing demand deposits	$ 105,960	$ 98,950
Interest bearing demand deposits	98,391	93,527
Savings deposits	75,345	66,207
Time deposits	205,644	256,677
Total Deposits	$ 485,340	$ 515,361

The average daily amount of deposits and rates paid on such deposits is summarized for the periods indicated in the following table:

	Year Ended December 31, (Dollars in Thousands)								
	2012			2011			2010		
	Amount	Rate		Amount	Rate		Amount	Rate	
Non-interest bearing demand deposits	$ 101,935	0.00	%	$ 95,419	0.00	%	$ 84,361	0.00	%
Interest-bearing demand deposits	94,770	0.46		92,050	0.69		79,288	0.89	
Savings deposits	72,629	0.30		64.998	0.38		58,835	0.52	
Time deposits	224,755	1.59		276,433	2.05		302,624	2.66	
Total	$494,089			$528,900			$525,108		

The remaining maturities of time deposits greater than or equal to $100,000 at December 31, 2012 are as follows (Amount in thousands):

Maturity	Amount
3 months or less	$ 10,741
Over 3 months through 6 months	10,782
Over 6 months through 12 months	10.616
Over 12 months	31,304
Total	$ 63,443

Effects of Inflation

The Company's consolidated statements of income generally reflect the effects of inflation. Since interest rates, loan demand, and deposit levels are related to inflation, the resulting changes are included in net income. The most significant item which does not reflect the effects of inflation is depreciation expense. Historical dollar values used to determine depreciation expense do not reflect the effects of inflation on the market value of depreciable assets after their acquisition.

Liquidity and Capital Resources
(dollar amounts in whole dollars)

Liquidity is the measure of the Bank’s ability to generate sufficient funds in order to meet customers’ demands for withdrawal of deposit balances and for the funding of loan requests. The Bank maintains cash reserves, in accordance with Federal Reserve Bank guidelines, and has sufficient flow of funds from investment security payments as well as loan payments to meet current liquidity needs.

Management of the Bank continuously monitors and plans the Bank's liquidity position for the future. Liquidity is provided from cash and due from banks, federal funds sold, loan and investment security payments, core deposits, the national certificate of deposit market, lines of credit with correspondent banks and lines of credit with the Federal Home Loan Bank. Management believes that the current cash on hand and other sources of funds provide sufficient and timely liquidity for the foreseeable future. The Bank currently has approximately $31,000,000 of available credit with the FHLB and $6,000,000 of available secured credit with its correspondent banks.

The Company's liquidity ultimately depends on dividends paid by the Bank, its wholly owned subsidiary. The Company and the Bank are currently prohibited from paying a dividend without the prior approval of the Federal Reserve Bank.

On April 27, 2009, the Company announced that it entered into a $7,500,000 Loan Commitment Agreement with Community Bankers Bank ("CBB"), pursuant to which CBB agreed to extend to the Company an aggregate of $7,500,000 under a Revolving Line of Credit of up to $3,000,000 ("Loan A") and a Closed-End Term Loan of up to $4,500,000 ("Loan B") (collectively, the "Loans"). The Company pledged the stock of the Bank as collateral for the Loans. Proceeds of the loans of $3,200,000 were down-streamed into the Bank as additional Tier 1 capital with the remaining proceeds of $2,300,000 held in cash by the Company. Subsequently, during the second quarter of 2011, the Company requested and CBB agreed to modify the closed-end loan to extend the amortization period of the loan for a new 20-year period. The Company simultaneously paid off the Revolving Line of Credit. The Closed – End Term Loan has a balloon maturity in April 2014 and the Company deposited the monthly payments up to the balloon date into a reserve account held at CBB. The Closed – End Term Loan had a balance of $3,549,638 at December 31, 2012.

Recent Accounting Pronouncements

See Note 1 of Notes to Consolidated Financial Statements for information relating to recent accounting pronouncements.

Off-Balance Sheet Arrangements

See Note 16 of Notes to Consolidated Financial Statements for information relating to Off-Balance Sheet Arrangements.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk

Not Applicable

Item 8. Financial Statements and Supplementary Data

The following financial statements are incorporated by reference from the Annual Report to Shareholders for the fiscal year ended December 31, 2012:

Report of Independent Registered Public Accounting Firm on the Financial Statements;
Consolidated Balance Sheets as of December 31, 2012 and 2011;
Consolidated Statements of Income for the years ended December 31, 2012 and 2011;
Consolidated Statements of Comprehensive Income for the years ended December 31, 2012 and 2011;
Consolidated Statements of Stockholders' Equity for the years ended December 31, 2012 and 2011;
Consolidated Statements of Cash Flows for the years ended December 31, 2012 and 2011; and
Notes to Consolidated Financial Statements for December 31, 2012

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

None.

Item 9A. Controls and Procedures

On an on-going basis, senior management monitors and reviews the internal controls established for the various operating activities of the Company. Additionally, the Company has created a Disclosure Review Committee to review not only internal controls but the information used by Company's financial officers to prepare the Company's periodic SEC filings and corresponding financial statements. The Committee is comprised of the Senior Management Team of the Company and meets at least quarterly. Internal audits conducted by the Company's internal audit department are also reviewed by senior officers to assist them in assessing the adequacy of the Company's internal control structure. These audits are also discussed in detail with the Company's Audit Committee.

We have carried out an evaluation, under the supervision and the participation of our management, including our Executive Vice President and Chief Executive Officer, our Chief Financial Officer and our Vice President of Accounting, of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Act") as of the end of the fiscal year covered by this report. Based upon that evaluation, our CEO, CFO and VP Accounting concluded that our disclosure controls and procedures are effective in providing reasonable assurance that (a) the information required to be disclosed by us in the reports that we file or submit under the Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms, and (b) such information is accumulated and communicated to our management, including our CEO, CFO and VP Accounting, as appropriate to allow timely decisions regarding required disclosure.

Management's Annual Report on Internal Control over Financial Reporting is incorporated by reference from the Consolidated Financial Report to Shareholders for the fiscal year ended December 31, 2012.

There were not any changes in the Company's internal controls over financial reporting during the fourth fiscal quarter of the fiscal year covered by this report that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Item 9B. Other Information

None

Part III.

Item 10. Directors, Executive Officers and Corporate Governance

Pursuant to General Instruction G(3) of Form 10-K, the information contained under the headings "The Nominees," "Executive Officers Who Are Not Directors," "Section 16(a) Beneficial Ownership Reporting Compliance," "The Board of Directors and its Committees" and "Code of Ethics" in the Company's Proxy Statement for the 2013 Annual Meeting of Shareholders is incorporated herein by reference.

Item 11. Executive Compensation

Pursuant to General Instruction G(3) of Form 10-K, the information contained under the headings "Executive Compensation" in the Company's Proxy Statement for the 2013 Annual Meeting of Shareholders is incorporated herein by reference.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

Pursuant to General Instruction G(3) of Form 10-K, the information contained under the heading "Security Ownership of Management and Certain Beneficial Owners" in the Company's Proxy Statement for the 2013 Annual Meeting of Shareholders is incorporated herein by reference.

The following table sets forth information as of December 31, 2012, with respect to compensation plans under which shares of Common Stock are authorized for issuance.

Equity Compensation Plan Information

Plan Category	Number of Securities to Be Issued upon Exercise of Outstanding Options, Warrants and Rights	Weighted Average Exercise Price of Outstanding Options, Warrants and Rights	Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (a)
Equity Compensation Plans Approved by Shareholders	151,600	$ 14.24	--
Equity Compensation Plans Not Approved by Shareholders (b)	-	$ -	200,000
Total	151,600	$ 14.24	200,000

(a) Amounts exclude any securities to be issued upon exercise of outstanding options, warrants and rights.

(b) On September 13, 2006, the Board of Directors of the Company approved the Highlands Bankshares, Inc. 2006 Equity Compensation Plan (the Plan). The Plan authorizes the Personnel and Compensation Committee (the Committee) of the Board of Directors to grant options, stock appreciation rights, stock awards and stock units to directors, officers, key employees, consultants and advisors to the Company and its subsidiaries who are designated by the Committee. The Company is authorized to issue under the Plan up to 200,000 shares of its Common Stock. Generally, if an award is forfeited, expires or terminates, the shares allocated to that award under the Plan may be reallocated to new awards under the Plan. Shares surrendered pursuant to the exercise of a stock option or other award or in satisfaction of tax withholding requirements under the Plan may also be reallocated to other awards.

Item 13. Certain Relationships and Related Transactions, and Director Independence

Pursuant to General Instruction G(3) of Form 10-K, the information contained under the heading “Transactions with Related Parties” and “The Board of Directors and its Committees” in the Company’s Proxy Statement for the 2013 Annual Meeting of Shareholders is incorporated herein by reference.

Item 14. Principal Accounting Fees and Services

Pursuant to General Instruction G(3) of Form 10-K, the information contained under the headings “Services and Fees” and “Pre-Approved Policies and Procedures” in the Company’s Proxy Statement for the 2013 Annual Meeting of Shareholders is incorporated herein by reference.

Part IV.

Item 15. Exhibits, Financial Statement Schedules

(a) (1) The response to this portion of Item 15 is submitted as a separate section of this report.

(2) All applicable financial statement schedules required by Regulation S-X are included in the Notes to the 2012 Consolidated Financial Statements.

(3) Exhibits:

3.1	Amended and Restated Articles of Incorporation of Highlands Bankshares, Inc., filed as Exhibit 3.1 to the Quarterly Report on Form 10-Q for the period ended March 31, 2009.
3.2	Bylaws of Highlands Bankshares, Inc. attached as Exhibit 3.2 to the Registration Statement on Form 8-A, File No. 000-27622, filed with the Commission on January 24, 1996, incorporated herein by reference.
10.1	Highlands Union Bank 1995 Stock Option Plan, attached as Exhibit 10.1 to the Annual Report on Form 10-K for the fiscal year ended December 31, 2002, File No. 000-27622, incorporated herein by reference.
10.2	Highlands Bankshares, Inc. 2006 Equity Compensation Plan, filed as Exhibit 3.1 to the Current Report on Form 8-K, File No. 000-27622, filed with the Commission on September 20, 2006, incorporated herein by reference.
10.3	Written Agreement, dated October 13, 2010, between Highlands Bankshares, Inc., Highlands Union Bank and the Federal Reserve Bank of Richmond, attached as Exhibit 10.1 to the Current Report on Form 8-K, File No. 000-27622, filed with the Commission on October 19, 2010, incorporated herein by reference.
13.1	Annual Report to Shareholders – Financial Statements

21	Subsidiaries of the Corporation.
23.1	Consent of Brown, Edwards & Company, L.L.P.

44

31.1	Section 302 Certification of Chief Executive Officer.
31.2	Section 302 Certification of Chief Financial Officer of the Corporation
31.3	Section 302 Certification of Vice President of Accounting
32.1	Statement of Chief Executive Officer Pursuant to 18 U.S.C. § 1350.
32.2	Statement of Chief Financial Officer of the Corporation Pursuant to 18 U.S.C. § 1350.
32.3	Statement of Vice President of Accounting Pursuant to 18 U.S.C. § 1350.
101	The following materials from the Registrant’s Annual Report on Form 10-K for the year ended December 31, 2012, formatted in Extensible Business Reporting Language (XBRL), include: (i) the Consolidated Balance Sheets, (ii) the Consolidated Statements of Income, (iii) the Consolidated Statements of Comprehensive Income, (iv) Consolidated Statements of Cash Flows; (v) Consolidated Statements of Changes in Stockholders' Equity and (vi) related notes (furnished herewith).

(b) Exhibits.

The response to this portion of Item 15 as listed in Item 15(a)(3) above is submitted as a separate section of this report.

(c) Financial Statement Schedules. The response to this portion of Item 15 is submitted as a separate section of this report.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

		HIGHLANDS BANKSHARES, INC.	
Date: March 29, 2013		BY:	/s/ Samuel L. Neese Samuel L. Neese Executive Vice President and Chief Executive Officer
BY:	/s/ Robert M. Little, Jr Robert M. Little, Jr. Chief Financial Officer Principal Financial Officer	BY	/s/ James R. Edmondson James R. Edmondson Vice President of Accounting Principal Accounting Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated on March 29, 2013.

Signature	Title	Date
/s/ James D. Morefield James D. Morefield	Chairman of the Board, and Director	March 29, 2013
/s/ Dr. James D. Moore, Jr. Dr. James D. Moore, Jr.	President	March 29, 2013
/s/ J. Carter Lambert J. Carter Lambert	Vice Chairman	March 29, 2013
/s/ Samuel L. Neese Samuel L. Neese	Executive Vice President, and Chief Executive Officer (principal executive officer)	March 29, 2013
/s/ E. Craig Kendrick E. Craig Kendrick	Director	March 29, 2013

Signature	Title	Date
/s/ Clydes B. Kiser Clydes B. Kiser	Director	March 29, 2013
/s/ Charles P. Olinger Charles P. Olinger	Director	March 29, 2013
/s/ H. Ramsey White, Jr H. Ramsey White, Jr	Director	March 29, 2013

EXHIBIT INDEX

Exhibit No.	Description
3.1	Amended and Restated Articles of Incorporation of Highlands Bankshares, Inc., filed as Exhibit 3.1 to the Quarterly Report on Form 10-Q for the period ended March 31, 2009.
3.2	Bylaws of Highlands Bankshares, Inc. attached as Exhibit 3.2 to the Registration Statement on Form 8-A, File No. 000-27622, filed with the Commission on January 24, 1996, incorporated herein by reference.
10.1	Highlands Union Bank 1995 Stock Option Plan, attached as Exhibit 10.1 to the Annual Report on Form 10-K for the fiscal year ended December 31, 2002, File No. 000-27622, incorporated herein by reference.
10.2	Highlands Bankshares, Inc. 2006 Equity Compensation Plan, filed as Exhibit 3.1 to the Current Report on Form 8-K, File No. 000-27622, filed with the Commission on September 20, 2006, incorporated herein by reference
10.3	Written Agreement, dated October 13, 2010, between Highlands Bankshares, Inc., Highlands Union Bank and the Federal Reserve Bank of Richmond, attached as Exhibit 10.1 to the Current Report on Form 8-K, File No. 000-27622, filed with the Commission on October 19, 2010, incorporated herein by reference.
13.1	Annual Report to Shareholders – Financial Statements
21	Subsidiaries of the Corporation.
23.1	Consent of Brown, Edwards & Company, L.L.P.
31.1	Section 302 Certification of Chief Executive Officer.
31.2	Section 302 Certification of Chief Financial Officer of the Corporation
31.3	Section 302 Certification of Vice President of Accounting of the Bank.
32.1	Statement of Chief Executive Officer Pursuant to 18 U.S.C. § 1350.
32.2	Statement of Chief Financial Officer of the Corporation Pursuant to 18 U.S.C. § 1350.
32.3	Statement of Vice President of Accounting Pursuant to 18 U.S.C. § 1350.
101	The following materials from the Registrant's Annual Report on Form 10-K for the year ended December 31, 2012, formatted in Extensible Business Reporting Language (XBRL), include: (i) the Consolidated Balance Sheets, (ii) the Consolidated Statements of Income, (iii) the Consolidated Statements of Comprehensive Income, (iv) Consolidated Statements of Cash Flows; (v) Consolidated Statements of Changes in Stockholders' Equity and (vi) related notes (furnished herewith).