EVANS BANCORP INC
Form 10-Q
August 05, 2011
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United States

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For quarterly period ended June 30, 2011

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from to

Commission file number 001-35021

EVANS BANCORP, INC.

(Exact name of registrant as specified in its charter)

New York **(State or other jurisdiction of incorporation or organization)**	**16-1332767** **(I.R.S. Employer Identification No.)**
14 -16 North Main Street, Angola, New York **(Address of principal executive offices)**	**14006** **(Zip Code)**

(716) 926-2000

(Registrant s telephone number, including area code)

Not applicable

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

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

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 ¨

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

Large accelerated filer ¨	Accelerated filer ¨
Non-accelerated filer ¨ (Do not check if smaller reporting company)	Smaller reporting company x

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

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date:

Common Stock, $.50 par value: 4,108,103 shares as of August 1, 2011

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PART I FINANCIAL INFORMATION

ITEM I FINANCIAL STATEMENTS

EVANS BANCORP, INC. AND SUBSIDIARIES

UNAUDITED CONSOLIDATED BALANCE SHEETS

JUNE 30, 2011 AND DECEMBER 31, 2010

(in thousands, except share and per share amounts)

	June 30, 2011	December 31, 2010
ASSETS		
Cash and due from banks	$ 13,509	$ 13,467
Interest-bearing deposits at banks	14,106	255
Securities:		
Available for sale, at fair value (cost: $89,269 at June 30, 2011; $86,096 at December 31, 2010)	92,007	87,422
Held to maturity, at amortized cost (fair value: $2,482 at June 30, 2011; $2,130 at December 31, 2010)	2,487	2,140
Federal Home Loan Bank common stock, at amortized cost and fair value	1,830	2,362
Federal Reserve Bank common stock, at amortized cost and fair value	1,415	1,408
Loans and leases, net of allowance for loan and lease losses of $10,667 in 2011 and $10,424 in 2010	531,827	517,554
Properties and equipment, net of depreciation of $12,570 in 2011 and $12,054 in 2010	10,503	10,841
Goodwill	8,101	8,101
Intangible assets	912	1,168
Bank-owned life insurance	12,603	12,389
Other assets	13,532	14,416
TOTAL ASSETS	$ 702,832	$ 671,523
LIABILITIES AND STOCKHOLDERS EQUITY		
LIABILITIES		
Deposits:		
Demand	$ 104,814	$ 98,016
NOW	44,193	32,683
Regular savings	277,564	249,410
Muni-vest	26,333	22,000
Time	133,863	142,348
Total deposits	586,767	544,457
Securities sold under agreement to repurchase	5,581	5,227
Other short-term borrowings	3,010	13,669
Other liabilities	10,831	11,776
Junior subordinated debentures	11,330	11,330
Long-term borrowings	19,000	22,000
Total liabilities	636,519	608,459
CONTINGENT LIABILITIES AND COMMITMENTS		
STOCKHOLDERS EQUITY:		

Common stock, $.50 par value, 10,000,000 shares authorized; 4,108,103 at June 30, 2011 and 4,081,960 at December 31, 2010 shares issued and outstanding, respectively,	2,054	2,041
Capital surplus	40,961	40,660
Retained earnings	22,867	20,836
Accumulated other comprehensive income (loss), net of tax	431	(473)
Total stockholders equity	66,313	63,064
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$ 702,832	$ 671,523

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EVANS BANCORP, INC. AND SUBSIDIARIES

UNAUDITED CONSOLIDATED STATEMENTS OF INCOME

THREE MONTHS ENDED JUNE 30, 2011 AND 2010

(in thousands, except share and per share amounts)

	Three Months Ended June 30,	
	2011	2010
INTEREST INCOME		
Loans and leases	$ 7,081	$ 7,049
Interest bearing deposits at banks	7	3
Securities:		
Taxable	538	381
Non-taxable	389	403
Total interest income	8,015	7,836
INTEREST EXPENSE		
Deposits	1,461	1,420
Other borrowings	185	234
Junior subordinated debentures	82	83
Total interest expense	1,728	1,737
NET INTEREST INCOME	6,287	6,099
PROVISION FOR LOAN AND LEASE LOSSES	1,009	309
NET INTEREST INCOME AFTER PROVISION FOR LOAN AND LEASE LOSSES	5,278	5,790
NON-INTEREST INCOME		
Bank charges	416	480
Insurance service and fees	1,601	1,629
Data center income	192	198
Net gain on sales and calls of securities		13
Gain on loans sold	20	16
Bank-owned life insurance	110	133
Other	586	510
Total non-interest income	2,925	2,979
NON-INTEREST EXPENSE		
Salaries and employee benefits	3,912	3,727
Occupancy	816	710
Repairs and maintenance	155	179
Advertising and public relations	247	257
Professional services	407	388
Technology and communications	220	163
Amortization of intangibles	126	228
FDIC insurance	135	217
Other	744	679

Total non-interest expense	6,762	6,548
INCOME BEFORE INCOME TAXES	1,441	2,221
INCOME TAX PROVISION	469	590
NET INCOME	$ 972	$ 1,631
Net income per common share-basic	$ 0.24	$ 0.47
Net income per common share-diluted	$ 0.24	$ 0.47
Cash dividends per common share	$ 0.00	$ 0.00
Weighted average number of common shares outstanding	4,100,201	3,456,562
Weighted average number of diluted shares outstanding	4,106,371	3,460,225

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EVANS BANCORP, INC. AND SUBSIDIARIES

UNAUDITED CONSOLIDATED STATEMENTS OF INCOME

SIX MONTHS ENDED JUNE 30, 2011 AND 2010

(in thousands, except share and per share amounts)

	Six Months Ended June 30,	
	2011	2010
INTEREST INCOME		
Loans and leases	$ 14,233	$ 13,990
Interest bearing deposits at banks	11	4
Securities:		
Taxable	1,024	782
Non-taxable	760	805
Total interest income	16,028	15,581
INTEREST EXPENSE		
Deposits	2,882	2,769
Other borrowings	400	472
Junior subordinated debentures	163	163
Total interest expense	3,445	3,404
NET INTEREST INCOME	12,583	12,177
PROVISION FOR LOAN AND LEASE LOSSES	1,497	1,523
NET INTEREST INCOME AFTER PROVISION FOR LOAN AND LEASE LOSSES	11,086	10,654
NON-INTEREST INCOME		
Bank charges	802	991
Insurance service and fees	3,690	3,875
Data center income	431	432
Net gain on sales and calls of securities		7
Gain on loans sold	72	25
Bank-owned life insurance	213	241
Other	1,178	1,110
Total non-interest income	6,386	6,681
NON-INTEREST EXPENSE		
Salaries and employee benefits	7,816	7,334
Occupancy	1,593	1,481
Repairs and maintenance	314	361
Advertising and public relations	377	358
Professional services	809	802
Technology and communications	454	388
Amortization of intangibles	256	458
FDIC Insurance	364	443
Other	1,383	1,374

Total non-interest expense		13,366		12,999
INCOME BEFORE INCOME TAXES		4,106		4,336
INCOME TAX PROVISION		1,259		1,258
NET INCOME	$	2,847	$	3,078
Net income per common share-basic	$	0.70	$	0.98
Net income per common share-diluted	$	0.69	$	0.98
Cash dividends per common share	$	0.20	$	0.20
Weighted average number of common shares outstanding		4,092,896		3,139,118
Weighted average number of diluted shares outstanding		4,100,635		3,142,311

See Notes to Unaudited Consolidated Financial Statements

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PART 1 FINANCIAL INFORMATION

ITEM 1 FINANCIAL STATEMENTS

EVANS BANCORP, INC. AND SUBSIDIARIES

UNAUDITED CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY

SIX MONTHS ENDED JUNE 30, 2011 AND 2010

(in thousands, except share and per share amounts)

	Common Stock	Capital Surplus	Retained Earnings	Accumulated Other Comprehensive (Loss) Income	Total
Balance, January 1, 2010	$ 1,407	$ 27,279	$ 17,381	($ 108)	$ 45,959
Comprehensive income:					
Net Income			3,078		3,078
Unrealized gain on available-for-sale securities, net of reclassification of gain of $4 (after tax), net of tax effect of ($406)				657	657
Amortization of prior service cost and net loss net of tax effect of ($27)				40	40
Total comprehensive income					3,775
Cash dividends ($0.20 per common share)			(565)		(565)
Stock options expense		103			103
Issued 1,222,000 shares in common stock offering	611	12,824			13,435
Issued 5,996 shares under dividend reinvestment plan	3	84			87
Issued 10,250 shares under employee stock purchase plan	5	94			99
Issued 15,810 restricted shares	8	(8)			
Balance, June 30, 2010	$ 2,034	$ 40,376	$ 19,894	$ 589	$ 62,893
Balance, January 1, 2011	$ 2,041	$ 40,660	$ 20,836	($ 473)	$ 63,064
Comprehensive income:					
Net Income			2,847		2,847
Unrealized gain on available-for-sale securities, net of tax effect of ($547)				865	865
Amortization of prior service cost and net loss net of tax effect of ($23)				39	39
Total comprehensive income					3,751
Cash dividends ($0.20 per common share)			(816)		(816)
Excess tax benefit from stock-based compensation		9			9
Stock options expense		127			127
Issued 6,172 shares under dividend reinvestment plan	3	84			87
Issued 7,784 shares under employee stock purchase plan	4	87			91
Issued 12,260 restricted shares	6	(6)			
Balance, June 30, 2011	$ 2,054	$ 40,961	$ 22,867	$ 431	66,313

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EVANS BANCORP, INC. AND SUBSIDIARIES

UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS

SIX MONTHS ENDED JUNE 30, 2011 AND 2010

(in thousands)

	Six Months Ended June 30,	
	2011	2010
OPERATING ACTIVITIES:		
Interest received	$ 15,833	$ 15,639
Fees received	6,327	6,583
Interest paid	(3,493)	(3,376)
Cash paid to employees and vendors	(12,007)	(10,736)
Income taxes paid	(1,712)	(2,380)
Proceeds from sale of loans held for resale	13,116	4,821
Originations of loans held for resale	(15,590)	(4,755)
Net cash provided by operating activities	2,474	5,796
INVESTING ACTIVITIES:		
Available for sales securities:		
Purchases	(10,290)	(76,737)
Proceeds from maturities and calls	7,470	59,364
Held to maturity securities:		
Purchases	(435)	
Proceeds from maturities and calls	91	282
Additions to properties and equipment	(176)	(1,983)
Sale of other real estate		96
Increase in loans, net of repayments	(13,609)	(14,450)
Net cash used in investing activities	(16,949)	(33,428)
FINANCING ACTIVITIES:		
Proceeds from borrowings		5,671
Repayments of borrowings	(13,304)	(19,145)
Net increase in deposits	42,310	36,068
Dividends paid	(816)	(565)
Issuance of common stock	178	13,621
Net cash provided by financing activities	28,368	35,650
Net increase in cash and equivalents	13,893	8,018
CASH AND CASH EQUIVALENTS:		
Beginning of period	13,722	12,983
End of period	$ 27,615	$ 21,001

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EVANS BANCORP, INC. AND SUBSIDIARIES

UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS

SIX MONTHS ENDED JUNE 30, 2011 AND 2010

(in thousands)

	Six Months Ended June 30,	
	2011	2010
RECONCILIATION OF NET INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES:		
Net income	$ 2,847	$ 3,078
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	662	923
Deferred tax expense	109	13
Provision for loan and lease losses	1,497	1,523
Net gain on sales of assets		(1)
Premium on loans sold	(72)	(25)
Stock options expense	127	103
Proceeds from sale of loans held for resale	13,116	4,821
Originations of loans held for resale	(15,590)	(4,755)
Changes in assets and liabilities affecting cash flow:		
Other assets	(607)	(1,487)
Other liabilities	385	1,603
NET CASH PROVIDED BY OPERATING ACTIVITIES	$ 2,474	$ 5,796

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PART 1 FINANCIAL INFORMATION

ITEM 1 FINANCIAL STATEMENTS

EVANS BANCORP, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

THREE AND SIX MONTHS ENDED JUNE 30, 2011 AND 2010

1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The accounting and reporting policies followed by Evans Bancorp, Inc. (the Company), a financial holding company, and its two direct, wholly-owned subsidiaries: (i) Evans Bank, National Association (the Bank), and the Bank s subsidiaries, Evans National Leasing, Inc. (ENL), Evans National Holding Corp. (ENHC) and Suchak Data Systems, LLC (SDS); and (ii) Evans National Financial Services, LLC (ENFS), and ENFS s subsidiary, The Evans Agency, LLC (TEA) and TEA s subsidiaries, Frontier Claims Services, Inc. (FCS) and ENB Associates Inc. (ENBA), in the preparation of the accompanying interim unaudited consolidated financial statements conform with U.S. generally accepted accounting principles (GAAP) and with general practice within the industries in which it operates. Except as the context otherwise requires, the Company and its direct and indirect subsidiaries are collectively referred to in this report as the Company.

The accompanying consolidated financial statements are unaudited. In the opinion of management, all adjustments necessary for a fair presentation of the Company s financial position and results of operations for the interim periods have been made. Certain reclassifications have been made to the 2010 unaudited consolidated financial statements to conform to the presentation used in 2011.

The results of operations for the three and six month periods ended June 30, 2011 are not necessarily indicative of the results to be expected for the full year. The accompanying unaudited consolidated financial statements should be read in conjunction with the Audited Consolidated Financial Statements and the Notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2010. The Company has evaluated subsequent events for potential recognition and/or disclosure through the date of filing.

2. SECURITIES

The amortized cost of securities and their approximate fair value at June 30, 2011 and December 31, 2010 were as follows:

June 30, 2011
(in thousands)

	Amortized	Unrealized		Fair
	Cost	Gains	Losses	Value
Available for Sale:				
Debt securities:				
U.S. government agencies	$ 24,011	$ 866	$ (3)	$ 24,874
States and political subdivisions	34,411	1,036	(4)	35,443
Total debt securities	$ 58,422	$ 1,902	$ (7)	$ 60,317
Mortgage-backed securities:				
FNMA	$ 13,462	$ 451	$ (4)	$ 13,909
FHLMC	8,369	207		8,576
GNMA	6,577	163		6,740
CMO S	2,439	26		2,465
Total mortgage-backed securities	$ 30,847	$ 847	$ (4)	$ 31,690
Total securities designated as available for sale	$ 89,269	$ 2,749	$ (11)	$ 92,007
Held to Maturity:				
Debt securities:				
U.S. government agencies				
States and political subdivisions	2,487	23	(28)	2,482
Total securities designated as held to maturity	$ 2,487	$ 23	$ (28)	$ 2,482
Total securities	$ 91,756	$ 2,772	$ (39)	$ 94,489

December 31, 2010
(in thousands)

	Amortized	Unrealized		Fair
	Cost	Gains	Losses	Value
Available for Sale:				
Debt securities:				
U.S. government agencies	$ 23,130	$ 609	$ (95)	$ 23,644
States and political subdivisions	35,796	726	(225)	36,297
Total debt securities	$ 58,926	$ 1,335	$ (320)	$ 59,941
Mortgage-backed securities:				
FNMA	$ 10,207	$ 320	$ (65)	$ 10,462
FHLMC	9,541	79	(53)	9,567
GNMA	4,763	38	0	4,801
CMO S	2,659	11	(19)	2,651
Total mortgage-backed securities	$ 27,170	$ 448	$ (137)	$ 27,481
Total securities designated as available for sale	$ 86,096	$ 1,783	$ (457)	$ 87,422
Held to Maturity:				
Debt securities:				
U.S. government agencies				
States and political subdivisions	2,140	22	(32)	2,130

Total securities designated as held to maturity	$ 2,140	$ 22	$ (32)	$ 2,130
Total securities	$ 88,236	$ 1,805	$ (489)	$ 89,552

Available for sale securities with a total fair value of $88.8 million and $65.6 million at June 30, 2011 and December 31, 2010, respectively, were pledged as collateral to secure public deposits and for other purposes required or permitted by law.

The Company uses the Federal Home Loan Bank of New York (FHLBNY   ) as its primary source of overnight funds and also has several long-term advances with FHLBNY. The Company had a total of $22.0 million and $35.6 million in borrowed funds with FHLBNY at June 30, 2011 and December 31, 2010, respectively. The Company has placed sufficient collateral in the form of residential and commercial real estate loans at FHLBNY that meet FHLB collateral requirements. As a member of the Federal Home Loan Bank (FHLB   ) System, the Bank is required to hold stock in FHLBNY. The Bank held $1.8 million and $2.4 million in FHLBNY stock as of June 30, 2011 and December 31, 2010, respectively, at fair value.

The scheduled maturities of debt and mortgage-backed securities at June 30, 2011 are summarized below. All maturity amounts are contractual maturities. Actual maturities may differ from contractual maturities because certain issuers have the right to call or prepay obligations with or without call premiums.

	June 30, 2011	
	Amortized cost	Estimated fair value
	(in thousands)	
Debt securities available for sale:		
Due in one year or less	$ 3,791	$ 3,837
Due after one year through five years	16,326	16,779
Due after five years through ten years	21,997	22,834
Due after ten years	16,308	16,867
	58,422	60,317
Mortgage-backed securities available for sale	30,847	31,690
	$ 89,269	$ 92,007
Debt securities held to maturity:		
Due in one year or less	$ 1,165	$ 1,162
Due after one year through five years	441	444
Due after five years through ten years	280	293
Due after ten years	601	583
	2,487	2,482
Mortgage-backed securities held to maturity		
	2,487	2,482
Total Securities	$ 91,756	$ 94,489

Information regarding unrealized losses within the Company   s available for sale securities at June 30, 2011 and December 31, 2010, is summarized below. The securities are primarily U.S. government-guaranteed agency securities or municipal securities. All unrealized losses are considered temporary and related to market interest rate fluctuations.

	June 30, 2011					
	Less than 12 months		12 months or longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(in thousands)					
Available for Sale:						
Debt securities:						
U.S. government agencies	$ 797	($ 3)	$	$	$ 797	($ 3)
States and political subdivisions	481	(4)			481	(4)
Total debt securities	$ 1,278	($ 7)	$	$	$ 1,278	($ 7)
Mortgage-backed securities:						
FNMA	$ 1,626	($ 4)	$	$	$ 1,626	($ 4)
FHLMC						
GNMA						
CMO S						
Total mortgage-backed securities	$ 1,626	($ 4)	$	$	$ 1,626	($ 4)
Held To Maturity:						
Debt securities:						
States and political subdivisions	$ 1,167	($ 6)	$ 567	($ 22)	$ 1,734	($ 28)
Total temporarily impaired securities	$ 4,071	($ 17)	$ 567	($ 22)	$ 4,638	($ 39)

	December 31, 2010					
	Less than 12 months		12 months or longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(in thousands)					
Available for Sale:						
Debt securities:						
U.S. government agencies	$ 3,705	($ 95)	$	$	$ 3,705	($ 95)
States and political subdivisions	9,144	(225)			9,144	(225)
Total debt securities	$ 12,849	($ 320)	$	$	$ 12,849	($ 320)
Mortgage-backed securities:						
FNMA	$ 3,113	($ 65)	$	$	$ 3,113	($ 65)
FHLMC	7,897	(53)			7,897	(53)
CMO S	2,011	(19)			2,011	(19)
Total mortgage-backed securities	$ 13,021	($ 137)	$	$	$ 13,021	($ 137)
Held To Maturity:						
Debt securities:						
States and political subdivisions	$ 466	($ 28)	$ 862	($ 4)	$ 1,328	($ 32)
Total temporarily impaired securities	$ 26,336	($ 485)	$ 862	($ 4)	$ 27,198	($ 489)

In regard to municipal securities, the Company s general investment policy is that in-state securities must be rated at least Moody s Baa (or equivalent) at the time of purchase. The Company reviews the ratings report and municipality financial statements and prepares a pre-purchase analysis report before the purchase of any municipal securities. Out-of-state issues must be rated by Moody s at least Aa (or equivalent) at the time of purchase. The Company did not own any out-of-state municipal bonds at June 30, 2011 or December 31, 2010. Bonds rated below A are reviewed periodically to ensure their continued credit worthiness. While purchase of non-rated municipal securities is permitted, such purchases are limited to bonds issued by municipalities in the Company s general market area. Those municipalities are typically customers of the Bank whose financial situation is familiar to management. The financial statements of the issuers of non-rated securities are reviewed by the Bank and a credit file of the issuers is kept on each non-rated municipal security with relevant financial information.

Although concerns have been raised in the marketplace recently about the health of municipal bonds, the Company has not experienced any credit troubles in this portfolio and does not believe any credit troubles are imminent. Aside from the non-rated municipal securities to local municipalities discussed above that are considered held-to-maturity, all of the Company s available-for-sale municipal bonds are investment-grade government obligation (G.O.) bonds. G.O. bonds are generally considered safer than revenue bonds because they are backed by the full faith and credit of the government while revenue bonds rely on the revenue produced by a particular project. All of the Company s municipal bonds are to municipalities in New York State. There has never been a default of a NY G.O. in the history of the state. Historical performance does not guarantee future performance, but the Company believes that it does indicate that the risk of loss on default of a G.O. municipal bond for the Company is relatively low.

Management has assessed the securities available for sale in an unrealized loss position at June 30, 2011 and December 31, 2010 and determined the decline in fair value below amortized cost to be temporary. In making this determination, management considered the period of time the securities were in a loss position, the percentage decline in comparison to the securities amortized cost, and the financial condition of the issuer (primarily government or government-sponsored enterprises). In addition, management does not intend to sell these securities and it is not more likely than not that the Company will be required to sell these securities before recovery of their amortized cost. Management believes the decline in fair value is primarily related to market interest rate fluctuations and not to the credit deterioration of the individual issuers.

The Company has not recorded any other-than-temporary impairment charges in 2011 or 2010, the gross unrealized losses amounted to less than 0.1% of the total fair value of the securities portfolio at June 30, 2011 and December 31, 2010, and the gross unrealized loss position decreased by $0.5 million from December 31, 2010 to June 30, 2011. Nevertheless, it remains possible that there could be deterioration in the asset quality of the securities portfolio in the future. The credit worthiness of the Company s portfolio is largely reliant on the ability of U.S. government sponsored agencies such as FHLB, Federal National Mortgage Association (FNMA), Government National Mortgage Association (GNMA), and Federal Home Loan Mortgage Corporation (FHLMC), and municipalities throughout New York State to meet their obligations. In addition, dysfunctional markets could materially alter the liquidity, interest rate, and pricing risk of the portfolio. The relatively stable past performance is not a guarantee for similar performance of the Company s securities portfolio going forward.

3. FAIR VALUE MEASUREMENTS

The Company follows the provisions of ASC Topic 820, Fair Value Measurements and Disclosures. Those provisions relate to financial assets and liabilities carried at fair value and fair value disclosures related to financial assets and liabilities. ASC Topic 820 defines fair value and specifies a hierarchy of valuation techniques based on the nature of the inputs used to develop the fair value measures. Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

There are three levels of inputs to fair value measurements:

Level 1, meaning the use of quoted prices for identical instruments in active markets;

Level 2, meaning the use of quoted prices for similar instruments in active markets or quoted prices for identical or similar instruments in markets that are not active or are directly or indirectly observable; and

Level 3, meaning the use of unobservable inputs.

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Observable market data should be used when available.

FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE ON A RECURRING BASIS

The following table presents for each of the fair-value hierarchy levels as defined in this footnote, those financial instruments which are measured at fair value on a recurring basis at June 30, 2011 and December 31, 2010:

	Level 1	Level 2	Level 3	Fair Value
June 30, 2011				
Securities available-for-sale:				
U.S. government agencies	$	$ 24,874	$	$ 24,874
States and political subdivisions		35,443		35,443
Mortgage-backed securities		31,690		31,690
Mortgage servicing rights			442	442
December 31, 2010				
Securities available-for-sale:				
U.S. government agencies	$	$ 23,644	$	$ 23,644
States and political subdivisions		36,297		36,297
Mortgage-backed securities		27,481		27,481
Mortgage servicing rights			388	388

Securities available for sale

Fair values for securities are determined using independent pricing services and market-participating brokers. The pricing service and brokers use a variety of techniques to arrive at fair value including market maker bids, quotes, and pricing models. Inputs to their pricing models include recent trades, benchmark interest rates, spreads, and actual and projected cash flows. Management obtains a single market quote or price estimate for each security. Securities available for sale are classified as Level 2 in the fair value hierarchy as the valuation provided by the third-party provider uses observable market data.

Mortgage servicing rights

Mortgage servicing rights (MSRs   ) do not trade in an active, open market with readily observable prices. Accordingly, the Company obtains the fair value of the MSRs using a third-party pricing provider. The provider determines the fair value by discounting projected net servicing cash flows of the remaining servicing portfolio. The valuation model used by the provider considers market loan prepayment predictions and other economic factors. The fair value of MSRs is mostly affected by changes in mortgage interest rates since rate changes cause the loan prepayment acceleration factors to increase or decrease. All assumptions are market driven. Mortgage servicing rights are classified within Level 3 of the fair value hierarchy as the valuation is model driven and primarily based on unobservable inputs.

The following table summarizes the changes in fair value for items measured at fair value (Level 3) on a recurring basis using significant unobservable inputs during the three and six month periods ended June 30, 2011:

Mortgage servicing rights - March 31, 2011	$ 435
Gains (losses) included in earnings	(41)
Mortgage originations	48
Mortgage servicing rights - June 30, 2011	$ 442

Mortgage servicing rights - December 31, 2010	$ 388
Gains (losses) included in earnings	(36)
Mortgage originations	90
Mortgage servicing rights - June 30, 2011	$ 442

FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE ON A NONRECURRING BASIS

The Company is required, on a nonrecurring basis, to adjust the carrying value of certain assets or provide valuation allowances related to certain assets using fair value measurements. The following table presents for each of the fair-value hierarchy levels as defined in this footnote, those financial instruments which are measured at fair value on a nonrecurring basis at June 30, 2011 and December 31, 2010:

	Level 1	Level 2	Level 3	Fair Value
June 30, 2011				
Impaired loans	$	$	$ 8,947	$ 8,947
December 31, 2010				
Impaired loans	$	$	$ 7,787	$ 7,787

Impaired loans

The Company evaluates and values impaired loans at the time the loan is identified as impaired, and the fair values of such loans are estimated using Level 3 inputs in the fair value hierarchy. Fair value is estimated based on the value of the collateral securing these loans. Collateral may consist of real estate and/or business assets including equipment, inventory and/or accounts receivable and the value of these assets is determined based on appraisals by qualified licensed appraisers hired by the Company. Appraised and reported values may be discounted based on management s historical knowledge, changes in market conditions from the time of valuation, estimated costs to sell, and/or management s expertise and knowledge of the client and the client s business. The Company has an appraisal policy in which appraisals are obtained upon a loan being downgraded on the Company s internal loan rating scale to a 5 (special mention) or a 6 (substandard) depending on the amount of the loan, the type of loan and the type of collateral. All impaired loans are either graded a 6 or 7 on the internal loan rating scale. Subsequent to the downgrade, if the loan remains outstanding and impaired for at least one year more, management may require another follow-up appraisal. Between receipts of updated appraisals, if necessary, management may perform an internal valuation based on any known changing conditions in the marketplace such as sales of similar properties, a change in the condition of the collateral, or feedback from local appraisers. Impaired loans had a gross value of $9.9 million, with a valuation allowance of $1.0 million, at June 30, 2011, compared with a gross value of $9.3 million, with a valuation allowance of $1.5 million, at December 31, 2010.

FAIR VALUE OF FINANCIAL INSTRUMENTS

At June 30, 2011 and December 31, 2010, the estimated fair values of the Company s financial instruments, including those that are not measured and reported at fair value on a recurring basis or nonrecurring basis, were as follows:

	June 30, 2011		December 31, 2010	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
	(in thousands)		(in thousands)	
Financial assets:				
Cash and cash equivalents	$ 27,616	$ 27,616	$ 13,722	$ 13,722
Available for sale securities	92,007	92,007	87,422	87,422
Held to maturity securities	2,487	2,482	2,140	2,130
FHLB and FRB stock	3,245	3,245	3,770	3,770
Loans and leases, net	531,827	541,236	517,554	535,338
Mortgage servicing rights	442	442	388	388
Financial liabilities:				
Deposits	$ 586,767	$ 589,432	$ 544,457	$ 544,889
Other borrowed funds and securities soldunder agreements to repurchase	27,591	28,830	40,896	41,710
Junior subordinated debentures	11,330	11,330	11,330	11,330

The following methods and assumptions were used to estimate the fair value of each class of financial instruments for which it is practical to estimate that value.

Cash and Cash Equivalents. For these short-term instruments, the carrying amount is a reasonable estimate of fair value. Cash and Cash Equivalents includes interest-bearing deposits at other banks.

Securities available for sale. Fair values for available-for-sale securities are determined using independent pricing services and market-participating brokers. The pricing service and brokers use a variety of techniques to arrive at fair value including market maker bids, quotes, and pricing models. Inputs to their pricing models include recent trades, benchmark interest rates, spreads, and actual and projected cash flows. Management obtains a single market quote or price estimate for each security. These quoted prices reflect current information based on orderly transactions. These are considered Level 2 inputs under ASC 820.

Securities held to maturity. The Company holds certain municipal bonds as held-to-maturity. These bonds are generally small in dollar amount and are issued only by certain local municipalities within the Company s market area. The original terms are negotiated directly and on an individual basis consistent with our loan and credit guidelines. These bonds are not traded on the open market and management intends to hold the bonds to maturity. The fair value of held-to-maturity securities is estimated by discounting the future cash flows using the current rates at which similar agreements would be made with municipalities with similar credit ratings and for the same remaining maturities.

FHLB and FRB stock. The carrying value of FHLB and FRB stock approximate fair value.

Loans and Leases, net. The fair value of fixed rate loans is estimated by discounting the future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities, net of the appropriate portion of the allowance for loan losses. For variable rate loans, the carrying amount is a reasonable estimate of fair value. This fair value calculation is not necessarily indicative of the exit price, as defined in ASC 820.

Mortgage servicing rights. Mortgage servicing rights do not trade in an active, open market with readily observable prices. Accordingly, the Company obtains the fair value of the MSRs using a third-party pricing provider. The provider uses a combination of market and income valuation methodologies. All assumptions are market driven.

Deposits. The fair value of demand deposits, NOW accounts, muni-vest accounts and regular savings accounts is the amount payable on demand at the reporting date. The fair value of time deposits is estimated using the rates currently offered for deposits of similar remaining maturities.

Other Borrowed Funds and Securities Sold Under Agreement to Repurchase. The fair value of the short-term portion of other borrowed funds approximates its carrying value. The fair value of the long-term portion of other borrowed funds is estimated using a discounted cash flow analysis based on the Company s current incremental borrowing rates for similar types of borrowing arrangements.

Junior Subordinated Debentures. The carrying amount of Junior Subordinated Debentures is a reasonable estimate of fair value due to the fact that they bear a floating interest rate that adjusts on a quarterly basis.

Commitments to extend credit and standby letters of credit. As described in Note 7 - Contingent Liabilities and Commitments to these Unaudited Consolidated Financial Statements, the Company was a party to financial instruments with off-balance sheet risk at June 30, 2011 and December 31, 2010. Such financial instruments consist of commitments to extend permanent financing and letters of credit. If the options are exercised by the prospective borrowers, these financial instruments will become interest-earning assets of the Company. If the options expire, the Company retains any fees paid by the counterparty in order to obtain the commitment or guarantee. The fair value of commitments is estimated based upon fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the present creditworthiness of the counterparties. For fixed-rate commitments, the fair value estimation takes into consideration an interest rate risk factor. The fair value of guarantees and letters of credit is based on fees currently charged for similar agreements. The fair value of these off-balance sheet items at June 30, 2011 and December 31, 2010 approximates the recorded amounts of the related fees, which are not considered material.

4. LOANS, LEASES, AND THE ALLOWANCE FOR LOAN AND LEASE LOSSES

Loans

Loans that management has the intent and ability to hold for the foreseeable future, or until maturity or pay-off, generally are reported at their outstanding unpaid principal balances adjusted for unamortized deferred fees or costs. Interest income is accrued on the unpaid principal balance and is recognized using the interest method. Loan origination fees, net of certain direct origination costs, are deferred and recognized as an adjustment of the related loan yield using the effective yield method of accounting.

Loans become past due when the payment date has been missed. If payment has not been received within 30 days, then the loan is delinquent. Delinquent loans are placed into three categories; 30-59 days past due, 60-89 days past due, or 90+ days past due. Loans 90 or more days past due are considered non-performing.

The accrual of interest on loans is discontinued at the time the loan is 90 days delinquent, unless the credit is well secured and in process of collection. If the credit is not well secured and in the process of collection, the loan is placed on non-accrual status and is subject to charge-off if collection of principal or interest is considered doubtful.

All interest due but not collected for loans that are placed on non-accrual status or charged off is reversed against interest income. The interest on these loans is accounted for on the cost-recovery method, until it again qualifies for an accrual basis. Any cash receipts on non-accrual loans reduce the carrying value of the loans. Loans are returned to accrual status when all principal and interest amounts contractually due are brought current, the adverse circumstances which resulted in the delinquent payment status are resolved, and payments are made in a timely manner for a period of time sufficient to reasonably assure their future dependability.

The Bank considers a loan impaired when, based on current information and events, it is probable that it will be unable to collect principal or interest due according to the contractual terms of the loan. Commercial mortgage, commercial and industrial (C&I), and large balance leases (greater than $100,000) are identified for evaluation and individually considered impaired. These loans and leases are assessed for any impairment. Loan impairment is measured based on the present value of expected cash flows discounted at the loan s effective interest rate or, as a practical expedient, at the loan s observable market price or the fair value of the collateral if the loan is collateral dependent. Consumer loans and smaller balance leases are collectively evaluated for impairment. Since these loans and leases are not individually identified and evaluated, they are not considered impaired loans.

The Bank monitors the credit risk in its loan portfolio by reviewing certain credit quality indicators (CQI). The primary CQI for its commercial mortgage and C&I portfolios is the individual loan s credit risk rating. The following list provides a description of the credit risk ratings that are used internally by the Bank when assessing the adequacy of its allowance for loan and lease losses:

1-3-Pass: Risk Rated 1-3 loans are loans with a slight risk of loss. The loan is secured by collateral of sufficient value to cover the loan by an acceptable margin. The financial statements of the company demonstrate sufficient net worth and repayment ability. The company has established an acceptable credit history with the bank and typically has a proven track record of performance. Management is experienced, and has an at least average ability to manage the company. The industry has an average or less than average susceptibility to wide fluctuations in business cycles.

This risk rating includes all accruing consumer loans, including residential mortgages and home equities, that are less than 60 days past due.

4-Watch: Although generally acceptable, a higher degree of risk is evident in these watch credits. Obligor assessment factors may have elements which reflect marginally acceptable conditions warranting more careful review and analysis and monitoring.

The obligor s balance sheet reflects generally acceptable asset quality with some elements weak or marginally acceptable. Liquidity may be somewhat strained, but is at an acceptable level to support operations. Obligor may be fully leveraged with ratios higher than industry averages. High leverage is negatively impacting the company, leaving it vulnerable to adverse change. Inconsistent or declining capability to service existing debt requirements evidenced by debt service coverage temporarily below or near acceptable level. The margin of collateral may be adequate, but declining or fluctuating in value. Company management may be unproven, but capable. Rapid expansion or acquisition may increase leverage or reduce cash flow.

Negative industry conditions or weaker management could also be characteristic. Proper consideration should be given to companies in a high growth phase or in development business segments that may not have achieve sustainable earnings.

Obligors demonstrate sufficient financial flexibility to react to and positively address the root cause of the adverse financial trends without significant deviations from their current business strategy. The rating is also used for borrowers that have made significant progress in resolving their financial weaknesses.

5-O.A.E.M. (Other Assets Especially Mentioned): Special Mention (SM) A special mention asset has potential weaknesses that warrant management s close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the institution s credit position at some future date. SM assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification.

SM assets have potential weaknesses that may, if not checked or corrected, weaken the asset or inadequately protect the institution s position at some future date. These assets pose elevated risk, but their weakness does not yet justify a substandard classification. Borrowers may be experiencing adverse operating trends (declining revenues or margins) or an ill proportioned balance sheet (e.g. increasing inventory without an increase in sales, high leverage, tight liquidity).

Adverse economic or market conditions, such as interest rate increases or the entry of a new competitor, may also support a special mention rating.

Nonfinancial reasons for rating a credit exposure special mention include management problems, pending litigation, an ineffective loan agreement or other material structural weakness, and any other significant deviation from prudent lending practices.

The SM rating is designed to identify a specific level of risk and concern about asset quality. Although an SM asset has a higher probability of default than a pass asset, its default is not imminent.

This risk rating includes the pool of consumer loans, including residential mortgages and home equities, that are 60-89 days past due.

6-Substandard: A substandard asset is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified must have a well-defined weakness, or weaknesses, that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected. Substandard assets have a high probability of payment default, or they have other well-defined weaknesses. They require more intensive supervision by bank management.

Substandard assets are generally characterized by current or expected unprofitable operations, inadequate debt service coverage, inadequate liquidity, or marginal capitalization. Repayment may depend on collateral or other credit risk subsidies. For some substandard assets, the likelihood of full collection of interest and principal may be in doubt; such assets should be placed on non-accrual. Although substandard assets in the aggregate will have distinct potential for loss, an individual asset s loss potential does not have to be distinct for the asset to be rated substandard. These loans are periodically reviewed and tested for impairment.

This risk rating includes the pool of consumer loans, including residential mortgages and home equities, that are 90 or more days past due or in non-accrual status.

7-Doubtful: An asset classified doubtful has all the weaknesses inherent in one classified substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.
A doubtful asset has a high probability of total or substantial loss, but because of specific pending events that may strengthen the asset, its classification of loss is deferred.

Doubtful borrowers are usually in default, lack adequate liquidity or capital, and lack the resources necessary to remain an operating entity. Pending events can include mergers, acquisitions, liquidations, capital injections, the perfection of liens on additional collateral, the valuation of collateral, and refinancing.

Generally, pending events should be resolved within a relatively short period and the ratings will be adjusted based on the new information. Because of high probability of loss, non-accrual accounting treatment is required for doubtful assets.

8-Loss: Assets classified loss are considered uncollectable and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the assets have absolutely no recovery or salvage value, but rather that it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be achieved in the future.
With loss assets, the underlying borrowers are often in bankruptcy, have formally suspended debt repayments, or have otherwise ceased normal business operations. Once an asset is classified loss, there is little prospect of collecting either its principal or interest. When access to collateral, rather than the value of the collateral, is a problem, a less severe classification may be appropriate. However, management should not maintain an asset on the balance sheet if realizing its value would require long-term litigation or other lengthy recovery efforts. Losses are to be recorded in the period an obligation becomes uncollectible.

Leases

The Bank s leasing operations consist principally of the leasing of various types of small ticket commercial equipment. The Company follows ASC Topic 840, Leases, for all of its direct financing leases. The net investment in direct financing leases is the sum of all minimum lease payments and estimated residual values, less unearned income, net of the remaining mark. In the third quarter of 2009, the Company announced its intention to sell the leasing portfolio. As a result, the Company classified the leasing portfolio as held-for-sale and marked the portfolio down to its fair market value as of June 30, 2009. As of September 30, 2009, management decided to service the portfolio to maturity and transferred it to held-for-investment. The carrying value of the leasing portfolio amounted to $10.0 million and $15.5 million at June 30, 2011 and December 31, 2010, respectively. The CQI used for leases are delinquency and accruing status. The leasing CQI s are discussed in more detail in the *Credit Quality Indicators* section of this footnote.

Loan and Lease Portfolio Composition

The following table presents selected information on the composition of the Company s loan and lease portfolio as of the dates indicated:

	June 30, 2011	December 31, 2010
	(in thousands)	
Mortgage loans on real estate:		
Residential mortgages	$ 68,046	$ 69,958
Commercial and multi-family	278,339	261,371
Construction - residential	1,787	1,320
Construction - commercial	25,613	32,332
Home equities	54,385	53,120
Total real estate loans	428,170	418,101
Direct financing leases	9,957	15,475
Commercial and industrial loans	101,357	91,445
Consumer loans	1,898	2,458
Other	783	252
Net deferred loan origination costs	329	247
Total gross loans	542,494	527,978
Allowance for loan losses	(10,667)	(10,424)
Loans, net	$ 531,827	$ 517,554

Residential Mortgages: The Company originates adjustable-rate and fixed-rate, one-to-four-family residential real estate loans for the construction, purchase or refinancing of a mortgage. These loans are collateralized by owner-occupied properties located in the Company s market area. They are amortized over 10 to 30 years. Loans on one-to-four-family residential real estate are mostly originated in amounts of no more than 80% of appraised value or have private mortgage insurance. Mortgage title insurance and hazard insurance are normally required. Construction loans have a unique risk, because they are secured by an incomplete dwelling.

Due to the lack of foreclosure activity and absence of any ongoing litigation, the Company has no accrual for loss contingencies or potential costs associated with foreclosure-related activities.

The Bank sells certain fixed rate residential mortgages to FNMA, while maintaining the servicing rights for those mortgages. During the three month period ended June 30, 2011, the Bank sold mortgages to FNMA totaling $5.8 million, as compared with $2.8 million sold during the three month period ended June 30, 2010. During the six month period ended June 30, 2011, the Bank sold mortgages to FNMA totaling $13.1 million, as compared with $4.8 million during the six month period ended June 30, 2010. At June 30, 2011, the Bank had a loan servicing portfolio principal balance of $54.6 million upon which it earns servicing fees, as compared with $49.8 million at March 31, 2011 and $44.2 million at December 31, 2010. The value of the mortgage servicing rights for that portfolio was $0.4 million at June 30, 2011, March 31, 2011, and December 31, 2010. Residential mortgage loans held-for-sale were $0 at June 30, 2011 compared with $1.4 million at March 31, 2011 and $2.9 million at December 31, 2010. The Company has never been contacted by FNMA to repurchase any loans due to improper documentation or fraud, and no reserve for repurchases has been recorded.

Commercial and Multi-Family Mortgages: Commercial real estate loans are made to finance the purchases of real estate with completed structures or in the midst of being constructed. These commercial real estate loans are secured by first liens on the real estate, which may include apartments, hotels, retail stores or plazas, healthcare facilities, and other non-owner-occupied facilities. These loans are less risky than commercial and industrial loans, since they are secured by real estate and buildings. The Company offers commercial mortgage loans with up to an 80% LTV ratio for up to 20 years on a variable and fixed rate basis. Many of these mortgage loans either mature or are subject to a rate call after three to five years. The Company s underwriting analysis includes credit verification, independent appraisals, a review of the borrower s financial condition, and the underlying cash flows. These loans are typically originated in amounts of no more than 80% of the appraised value of the property. Construction loans have a unique risk, because they are secured by an incomplete dwelling.

Home Equities: The Company originates home equity lines of credit and second mortgage loans (loans secured by a second lien position on owner-occupied one-to-four-family residential real estate). These loans carry a higher risk than first mortgage residential loans as they are in a second position relating to collateral. Risk is reduced through underwriting criteria, which include credit verification, appraisals, a review of the borrower s financial condition, and personal cash flows. A security interest, with title insurance when necessary, is taken in the underlying real estate.

Direct Financing Leases: From January 2005 to April 2009 the Company originated direct financing leases of commercial small-ticket general business equipment to companies located throughout the United States. These leases carry a high risk of loss. As a result of the increase in credit risks, poor performance in the portfolio, the lack of strategic fit with the Company s community banking philosophy, and with the intention of reallocating capital back to its core business, management announced its exit from the national leasing business in April 2009. As a result of management s decision to sell the portfolio a mark-to-market adjustment of $7.2 million was made on June 30, 2009. The mark was charged off against the allowance. The portfolio was subsequently placed back into held-for-investment as of September 30, 2009 after management determined that a greater value for the portfolio would be realized by keeping it and servicing it to maturity rather than selling it. The portfolio was re-classified as held-for-investment using the same $7.2 million mark. Since that time, leases that are determined to have zero value have been applied to the remaining mark, rather than charged off through the allowance. There is an allowance for lease losses of $1.5 million at June 30, 2011.

Commercial and Industrial Loans: These loans generally include term loans and lines of credit. Such loans are made available to businesses for working capital (including inventory and receivables), business expansion (including acquisition of real estate, expansion and improvements) and equipment purchases. As a general practice, a collateral lien is placed on equipment or other assets owned by the borrower. These loans carry a higher risk than commercial real estate loans due to the nature of the underlying collateral, which typically consist of business assets such as equipment and accounts receivable. To reduce the risk, management also attempts to secure real estate as collateral and obtain personal guarantees of the borrowers. To further reduce risk and enhance liquidity, these loans generally carry variable rates of interest, re-pricing in three- to five-year periods, and have a maturity of ten years or less. Lines of credit generally carry floating rates of interest (e.g., prime plus a margin).

Consumer Loans: The Company funds a variety of consumer loans, including direct automobile loans, recreational vehicle loans, boat loans, aircraft loans, home improvement loans, and personal loans (collateralized and uncollateralized). Most of these loans carry a fixed rate of interest with principal repayment terms typically ranging up to five years, based upon the nature of the collateral and the size of the loan. The majority of consumer loans are underwritten on a secured basis using the underlying collateral being financed. A minimal amount of loans are unsecured, which carry a high risk of loss.

Other Loans: These loans include $1.2 million and $0.3 million at June 30, 2011 and December 31, 2010, respectively, of overdrawn deposit accounts classified as loans.

Net loan commitment fees or costs for commitment periods greater than one year are deferred and amortized into fee income or other expense on a straight-line basis over the commitment period.

Credit Quality Indicators

The following tables provide data, at the class level, of credit quality indicators of certain loans and leases for the dates specified:

June 30, 2011
(in thousands)

Corporate Credit **Exposure - By** **Credit Rating**	**Commercial** **Real Estate** **Construction**	**Commercial Real** **Estate Other**	**Total** **Commercial** **Real Estate**	**Commercial** **and** **Industrial**
3	$ 19,953	$ 232,814	$ 252,767	$ 68,646
4	2,744	34,282	$ 37,026	21,395
5	1,419	1,674	$ 3,093	5,874
6	1,497	9,569	$ 11,066	4,912
7				530
Total	$ 25,613	$ 278,339	$ 303,952	$ 101,357

December 31, 2010
(in thousands)

Corporate Credit **Exposure - By** **Credit Rating**	**Commercial** **Real Estate** **Construction**	**Commercial Real** **Estate Other**	**Total** **Commercial** **Real** **Estate**	**Commercial** **and** **Industrial**
3	$ 25,584	$ 212,825	$ 238,409	$ 60,728
4	2,703	37,393	40,096	19,692
5	2,565	2,176	4,741	4,699
6	1,480	8,977	10,457	4,966
7				1,360
Total	$ 32,332	$ 261,371	$ 293,703	$ 91,445

The Company s risk ratings are monitored by the individual relationship managers and changed as deemed appropriate after receiving updated financial information from the borrowers or deterioration or improvement in the performance of a loan is evident in the customer s payment history. Each commercial relationship is individually assigned a risk rating. The Company also maintains a loan review process that monitors the management of the Company s commercial loan portfolio by the relationship managers. The Company s loan review function reviews at least 40% of the commercial and commercial mortgage portfolio annually.

The Company s consumer loans, including residential mortgages and home equity loans, are not individually risk rated or reviewed in the Company s loan review process. Consumers are not required to provide the Company with updated financial information as a commercial customer is. Consumer loans are also smaller in balances. Given the lack of updated information since the initial underwriting of the loan and small size of individual loans, the Company uses the delinquency status as the credit quality indicator for consumer loans. The delinquency table is shown below. The Company does not lend to sub-prime borrowers. Unless the loan is well secured and in the process of collection, all consumer loans that are more than 90 days past due are placed in non-accrual status.

Similar to consumer loans, direct financing leases are evaluated in pools according to delinquency and accruing status rather than assigned risk ratings. Given the comparable lower credit quality of the leasing portfolio, leases are rarely kept in accruing status beyond 30 days past due. Non-accrual leases are assigned a reserve percentage based on the historical loss history of the Company s non-accrual lease portfolio. Evaluating non-accruing leases as a pool is appropriate as they are small-balance and homogeneous in nature. On a quarterly basis, large leases (defined as leases greater than $100,000 in balances) are evaluated for any deterioration not readily apparent through payment performance. If any risk factors become apparent during the review such as deteriorating financial performance for the customer s business or requests for a restructuring from the original terms of the contract, management places

those large leases that are performing from a payment perspective but have some indications of credit deterioration into a second pool. These large leases with additional risk are assigned a reserve percentage reflective of the additional risk characteristics while taking into account the adequate payment performance. The Company performs specific impairment tests for two large leases because they contain significantly different risk characteristics than the remaining leasing portfolio. One of the leases is with a local borrower with whom the Bank has a developed relationship and a restructuring plan is in place. The second lease is with a large public company that recently declared bankruptcy. The Bank is considered a secured creditor in the bankruptcy and has received payments as scheduled in 2011. While the two large leases have characteristics of troubled credits and are classified as nonaccrual, management does not believe these two leases have similar characteristics as compared with the remaining lease portfolio. Management believes appropriate reserves have been established on an individual basis for the two leases. All other leases are placed in a third pool and assigned a reserve percentage commensurate with the credit history of the Company s leasing portfolio, delinquency trends, non-accrual trends, charge-off trends, and general macro-economic factors.

Past Due Loans and Leases

The following tables provide an analysis of the age of the recorded investment in loans and leases that are past due as of the dates indicated:

June 30, 2011
(in thousands)

	30-59 days	60-89 days	90+ days	Total Past Due	Current Balance	Total Balance	90+ Days Accruing	Non-accruing Loans and Leases
Commercial and industrial	$ 1,442	$ 269	$ 1,241	$ 2,952	$ 98,405	$ 101,357	$ 21	$ 1,390
Residential real estate:								
Residential		542	141	683	67,363	68,046		688
Construction			180	180	1,607	1,787		180
Commercial real estate:								
Commercial		3,469	3,133	6,602	271,737	278,339		6,670
Construction			1,462	1,462	24,151	25,613		1,462
Home equities	478	113	234	825	53,560	54,385		478
Direct financing leases	428	62	874	1,364	8,593	9,957		1,747
Consumer	75	67	3	145	1,753	1,898		142
Other					1,112	1,112		
Total Loans	$ 2,423	$ 4,522	$ 7,268	$ 14,213	$ 528,281	$ 542,494	$ 21	$ 12,757

December 31, 2010
(in thousands)

	30-59 days	60-89 days	90+ days	Total Past Due	Current Balance	Total Balance	90+ Days Accruing	Non-accruing Loans and Leases
Commercial and industrial	$ 403	$ 200	$ 1,827	$ 2,430	$ 89,015	$ 91,445	$	$ 2,203
Residential real estate:								
Residential	684	393	662	1,739	68,219	69,958		696
Construction			186	186	1,134	1,320		186
Commercial real estate:								
Commercial	351	4,196	2,014	6,561	254,810	261,371		5,724
Construction	6,277		1,655	7,932	24,400	32,332	805	850
Home equities	437		118	555	52,565	53,120		256
Direct financing leases	609	224	1,578	2,411	13,064	15,475	1	2,930
Consumer	83	135	190	408	2,050	2,458		276
Other	1			1	498	499		
Total Loans	$ 8,845	$ 5,148	$ 8,230	$ 22,223	$ 505,755	$ 527,978	$ 806	$ 13,121

Allowance for loan and lease losses

The provision for loan and lease losses represents the amount charged against the Bank s earnings to maintain an allowance for probable loan and lease losses inherent in the portfolio based on management s evaluation of the loan and lease portfolio at the balance sheet date. Factors considered by the Bank s management in establishing the allowance include: the collectability of individual loans and leases, current loan and lease concentrations, charge-off history, delinquent loan and lease percentages, the fair value of the collateral, input from regulatory agencies, and general economic conditions.

On a quarterly basis, management of the Bank meets to review and determine the adequacy of the allowance for loan and lease losses. In making this determination, the Bank s management analyzes the ultimate collectability of the loans and leases in its portfolio by incorporating feedback provided by the Bank s internal loan and lease staff, an independent internal loan and lease review function and information provided by examinations performed by regulatory agencies.

The analysis of the allowance for loan and lease losses is composed of two components: specific credit allocation and general portfolio allocation. The specific credit allocation includes a detailed review of each impaired loan and allocation is made based on this analysis. Factors may include the appraisal value of the collateral, the age of the appraisal, the type of collateral, the performance of the loan to date, the performance of the borrower s business based on financial statements, and legal judgments involving the borrower. The general portfolio allocation consists of an assigned reserve percentage based on the historical loss experience and other quantitative and qualitative factors of the loan or lease category.

The general portfolio allocation is segmented into pools of loans with similar characteristics. Separate pools of loans include loans pooled by loan grade and by portfolio segment. The Company does not have sufficient meaningful data to perform a traditional loss migration analysis and thus has implemented alternative procedures. Loans graded 5 or worse (criticized loans) that exceed a material balance threshold are evaluated by the Company s credit department to determine if the collateral for the loan is worth less than the loan. All of these shortfalls are added together and divided by the respective loan pool to calculate the quantitative factor applied to the respective pool. These loans are not considered impaired because the cash flow of the customer and the payment history of the loan suggest that it is not probable that the Company will be unable to collect the full amount of principal and interest as contracted and are thus still accruing interest.

Loans that are graded 4 or better (non-criticized loans) are reserved in separate loan pools in the general portfolio allocation. A weighted average 5-year historical charge-off ratio by portfolio segment is calculated and applied against these loan pools.

For both the criticized and non-criticized loan pools in the general portfolio allocation, additional qualitative factors are applied. The qualitative factors applied to the general portfolio allocation reflect management s evaluation of various conditions. The conditions evaluated include the following: industry and regional conditions; seasoning of the loan and lease portfolio and changes in the composition of and growth in the loan and lease portfolio; the strength and duration of the business cycle; existing general economic and business conditions in the lending areas; credit quality trends in non-accruing loans and leases; timing of the identification of downgrades; historical loan and lease charge-off experience; and the results of bank regulatory examinations. Due to the nature of the loans, the criticized loan pools carry significantly higher qualitative factors than the non-criticized pools.

Direct financing leases are segregated from the rest of the loan portfolio in determining the appropriate allowance for that portfolio segment. Unlike the loan portfolio, the Company does have sufficient historical loss data to perform a migration analysis for non-accruing leases. Management periodically updates this analysis by examining the non-accruing lease portfolio at different points in time and studying what percentage of the non-accruing portfolio ends up being charged off. There are selected large leases in non-accruing status which carry different characteristics than the rest of the portfolio. The Company has more information on these particular lessees. The underwriting for these leases was different due to the size of the leases and the subsequent servicing of these leases was also more intensive. Due to the elevated level of information on these leases, the Company is able to specifically analyze these leases and allocate an appropriate specific reserve based on the information available including cash flow, payment history, and collateral value. These selected large leases are not considered when performing the migration analysis. All of the remaining leases not in non-accrual are allocated a reserve based on several factors including: delinquency and non-accrual trends, charge-off trends, and national economic conditions.

Changes in the allowance for loan and lease losses for the six months ended June 30, 2011 and 2010 are as follows:

	2011	2010
	(in thousands)	
Beginning balance, January 1	$ 10,424	$ 6,971
Provision for loan and lease losses	1,497	1,523
Recoveries	23	12
Loans and leases charged off	(1,277)	(201)
Ending balance, June 30	$ 10,667	$ 8,305

The following tables summarize the allowance for loan and lease losses according to portfolio segment, as of June 30, 2011: