FIDELITY D & D BANCORP INC
Form 10-Q
August 13, 2013
UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE

SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 2013

OR

[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE

SECURITIES EXCHANGE ACT OF 1934

For the transition period from ______________to______________________

Commission file number: 333-90273

FIDELITY D & D BANCORP, INC.

STATE OF INCORPORATION: IRS EMPLOYER IDENTIFICATION NO:

PENNSYLVANIA 23-3017653

Address of principal executive offices:

BLAKELY & DRINKER ST.

DUNMORE, PENNSYLVANIA 18512

TELEPHONE:

570-342-8281

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 subjected to such filing requirements for the past 90 days. [X] YES [ ] NO

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§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). [X] YES [ ] NO

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See 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 [ ] Smaller reporting company [X]

(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

[ ] YES [X] NO

The number of outstanding shares of Common Stock of Fidelity D & D Bancorp, Inc. on July 31, 2013, the latest practicable date, was 2,356,829 shares.

FIDELITY D & D BANCORP, INC.

Form 10-Q June 30, 2013

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PART I – Financial Information

Item 1: Financial Statements

Fidelity D & D Bancorp, Inc. and Subsidiary
Consolidated Balance Sheets
(Unaudited)

(dollars in thousands)	June 30, 2013	December 31, 2012
Assets:		
Cash and due from banks	$ 15,238	$ 12,657
Interest-bearing deposits with financial institutions	28	9,189
Total cash and cash equivalents	15,266	21,846
Available-for-sale securities	96,259	100,441
Held-to-maturity securities	207	289
Federal Home Loan Bank stock	3,214	2,624
Loans and leases, net (allowance for loan losses of $8,296 in 2013; $8,972 in 2012)	451,665	424,584
Loans held-for-sale (fair value $5,417 in 2013, $10,824 in 2012)	5,389	10,545
Foreclosed assets held-for-sale	2,617	1,607
Bank premises and equipment, net	13,802	14,127
Cash surrender value of bank owned life insurance	10,231	10,065
Accrued interest receivable	2,073	1,985
Other assets	14,452	13,412
Total assets	$ 615,175	$ 601,525
Liabilities:		
Deposits:		
Interest-bearing	$ 392,255	$ 388,625
Non-interest-bearing	127,268	126,035
Total deposits	519,523	514,660
Accrued interest payable and other liabilities	3,550	3,863
Short-term borrowings	16,199	8,056
Long-term debt	16,000	16,000
Total liabilities	555,272	542,579
Shareholders' equity:		
Preferred stock authorized 5,000,000 shares with no par value; none issued	-	-

Capital stock, no par value (10,000,000 shares authorized; shares issued and outstanding; 2,356,829 in 2013; and 2,323,248 in 2012)		24,454		23,711
Retained earnings		36,732		34,999
Accumulated other comprehensive (loss) income		(1,283)		236
Total shareholders' equity		59,903		58,946
Total liabilities and shareholders' equity	$	615,175	$	601,525

See notes to unaudited consolidated financial statements

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Fidelity D & D Bancorp, Inc. and Subsidiary
Consolidated Statements of Income

(Unaudited)	Three months ended		Six months ended	
(dollars in thousands except per share data)	June 30, 2013	June 30, 2012	June 30, 2013	June 30, 2012
Interest income:				
Loans and leases:				
Taxable	$ 5,335	$ 5,292	$ 10,705	$ 10,572
Nontaxable	121	116	220	252
Interest-bearing deposits with financial institutions	2	15	14	43
Investment securities:				
U.S. government agency and corporations	137	240	316	521
States and political subdivisions (nontaxable)	299	310	589	619
Other securities	18	18	36	36
Total interest income	5,912	5,991	11,880	12,043
Interest expense:				
Deposits	511	617	1,026	1,301
Securities sold under repurchase agreements	4	8	13	23
Other short-term borrowings and other	4	-	5	-
Long-term debt	213	213	423	452
Total interest expense	732	838	1,467	1,776
Net interest income	5,180	5,153	10,413	10,267
Provision for loan losses	600	600	1,150	1,300
Net interest income after provision for loan losses	4,580	4,553	9,263	8,967
Other income:				
Service charges on deposit accounts	459	424	911	843
Interchange fees	307	268	580	522
Fees from trust fiduciary activities	192	149	340	307
Fees from financial services	140	118	296	286
Service charges on loans	348	357	582	651
Fees and other revenue	119	97	221	169
Earnings on bank-owned life insurance	86	81	166	161
Gain (loss) on sale, recovery, or disposal of:				
Loans	390	434	894	829
Investment securities	9	7	128	261
Premises and equipment	1	(1)	1	(1)
Impairment losses on investment securities:				
Other-than-temporary impairment on investment securities	-	(31)	(61)	(241)
Non-credit-related losses on investment securities not expected to be sold (recognized in other comprehensive income (loss))	-	-	61	105
Net impairment losses on investment securities	-	(31)	-	(136)
Total other income	2,051	1,903	4,119	3,892
Other expenses:				
Salaries and employee benefits	2,422	2,294	4,896	4,651

Premises and equipment	805	806	1,660	1,704
Advertising and marketing	215	243	467	395
Professional services	328	365	577	671
FDIC assessment	123	127	249	249
Loan collection	168	180	363	301
Other real estate owned	61	104	184	159
Office supplies and postage	114	93	216	212
Other	370	497	875	1,118
Total other expenses	4,606	4,709	9,487	9,460
Income before income taxes	2,025	1,747	3,895	3,399
Provision for income taxes	512	430	988	825
Net income	$ 1,513	$ 1,317	$ 2,907	$ 2,574
Per share data:				
Net income - basic	$ 0.64	$ 0.57	$ 1.24	$ 1.13
Net income - diluted	$ 0.64	$ 0.57	$ 1.24	$ 1.13
Dividends	$ 0.25	$ 0.25	$ 0.50	$ 0.50

See notes to unaudited consolidated financial statements

Fidelity D & D Bancorp, Inc. and Subsidiary

Consolidated Statements of Comprehensive Income	Three months ended		Six months ended	
(Unaudited)	June 30,		June 30,	
(dollars in thousands)	2013	2012	2013	2012
Net income	$ 1,513	$ 1,317	$ 2,907	$ 2,574
Other comprehensive (loss) income, before tax:				
Unrealized holding (loss) gain on available-for-sale securities	(1,810)	514	(2,227)	1,013
Reclassification adjustment for net gains realized in income	(9)	(7)	(128)	(261)
Net impairment losses on investment securities	-	31	-	136
Net unrealized (loss) gain	(1,819)	538	(2,355)	888
Tax effect	619	(183)	801	(302)
Unrealized (loss) gain, net of tax	(1,200)	355	(1,554)	586
Non-credit-related impairment gain on investment securities not expected to be sold	92	238	53	282
Tax effect	(31)	(81)	(18)	(96)
Net non-credit-related impairment gain on investment securities	61	157	35	186
Other comprehensive (loss) income, net of tax	(1,139)	512	(1,519)	772
Total comprehensive income, net of tax	$ 374	$ 1,829	$ 1,388	$ 3,346

See notes to unaudited consolidated financial statements

Fidelity D & D Bancorp, Inc. and Subsidiary
Consolidated Statements of Changes in Shareholders' Equity
For the six months ended June 30, 2013 and 2012
(Unaudited)

(dollars in thousands)	Capital stock Shares	Amount	Retained earnings	Accumulated other comprehensive income (loss)	Total
Balance, December 31, 2011	2,254,542	$ 22,354	$ 32,380	$ (1,110)	$ 53,624
Net income			2,574		2,574
Other comprehensive income				772	772
Issuance of common stock through Employee Stock Purchase Plan	3,874	67			67
Issuance of common stock through Dividend Reinvestment Plan	32,099	644			644
Stock-based compensation expense		15			15
Cash dividends declared			(1,133)		(1,133)
Balance, June 30, 2012	2,290,515	$ 23,080	$ 33,821	$ (338)	$ 56,563
Balance, December 31, 2012	2,323,248	$ 23,711	$ 34,999	$ 236	$ 58,946
Net income			2,907		2,907
Other comprehensive loss				(1,519)	(1,519)
Issuance of common stock through Employee Stock Purchase Plan	4,256	78			78
Issuance of common stock through Dividend Reinvestment Plan	29,191	606			606
Issuance of common stock from vested restricted share grants through stock compensation plans	134				
Stock-based compensation expense		59			59
Cash dividends declared			(1,174)		(1,174)
Balance, June 30, 2013	2,356,829	$ 24,454	$ 36,732	$ (1,283)	$ 59,903

See notes to unaudited consolidated financial statements

Fidelity D & D Bancorp, Inc. and Subsidiary
Consolidated Statements of Cash Flows

(Unaudited)	Six months ended June 30,	
(dollars in thousands)	2013	2012
Cash flows from operating activities:		
Net income	$ 2,907	$ 2,574
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation, amortization and accretion	1,722	1,750
Provision for loan losses	1,150	1,300
Deferred income tax expense (benefit)	406	(225)
Stock-based compensation expense	59	15
Proceeds from sale of loans held-for-sale	50,623	39,972
Originations of loans held-for-sale	(42,730)	(32,995)
Earnings on bank-owned life insurance	(166)	(161)
Net gain from sales of loans	(894)	(829)
Net gain from sales of investment securities	(111)	(251)
Net loss on sale and write-down of foreclosed assets held-for-sale	87	75
(Gain) loss on disposal of equipment	(1)	1
Other-than-temporary impairment on securities	-	136
Change in:		
Accrued interest receivable	(94)	(61)
Other assets	(338)	51
Accrued interest payable and other liabilities	(271)	(3,812)
Net cash provided by operating activities	12,349	7,540
Cash flows from investing activities:		
Held-to-maturity securities:		
Proceeds from maturities, calls and principal pay-downs	82	52
Available-for-sale securities:		
Proceeds from sales	756	3,571
Proceeds from maturities, calls and principal pay-downs	15,838	15,505
Purchases	(15,374)	(20,885)
(Increase) decrease in FHLB stock	(590)	361
Net increase in loans and leases	(32,000)	(24,191)
Acquisition of bank premises and equipment	(467)	(936)
Proceeds from sale of foreclosed assets held-for-sale	310	164
Net cash used by investing activities	(31,445)	(26,359)
Cash flows from financing activities:		
Net increase (decrease) in deposits	4,863	(3,733)

Net increase (decrease) in short-term borrowings	8,143	(1,401)
Repayments of long-term debt	-	(5,000)
Proceeds from employee stock purchase plan participants	78	67
Dividends paid, net of dividends reinvested	(727)	(748)
Proceeds from dividend reinvestment plan participants	159	260
Net cash provided (used) by financing activities	12,516	(10,555)
Net (decrease) increase in cash and cash equivalents	(6,580)	(29,374)
Cash and cash equivalents, beginning	21,846	52,165
Cash and cash equivalents, ending	$ 15,266	$ 22,791

See notes to unaudited consolidated financial statements

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FIDELITY D & D BANCORP, INC.

Notes to Consolidated Financial Statements

(Unaudited)

1. Nature of operations and critical accounting policies

Nature of operations

Fidelity Deposit and Discount Bank (the Bank) is a commercial bank chartered in the Commonwealth of Pennsylvania and a wholly-owned subsidiary of Fidelity D & D Bancorp, Inc. (the Company or collectively, the Company). Having commenced operations in 1903, the Bank is committed to provide superior customer service, while offering a full range of banking products and financial and trust services to both our consumer and commercial customers from our main office located in Dunmore and other branches located throughout Lackawanna and Luzerne counties.

Principles of consolidation

The accompanying unaudited consolidated financial statements of the Company and the Bank have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) for interim financial information and with the instructions to this Form 10-Q and Rule 8-03 of Regulation S-X. Accordingly, they do not include all of the information and footnote disclosures required by GAAP for complete financial statements. In the opinion of management, all normal recurring adjustments necessary for a fair presentation of the financial condition and results of operations for the periods have been included. All significant inter-company balances and transactions have been eliminated in consolidation.

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reported periods. Actual results could differ from those estimates. For additional information and disclosures required under GAAP, refer to the Company’s Annual Report on Form 10-K for the year ended December 31, 2012.

Management is responsible for the fairness, integrity and objectivity of the unaudited financial statements included in this report. Management prepared the unaudited financial statements in accordance with GAAP. In meeting its responsibility for the financial statements, management depends on the Company's accounting systems and related internal controls. These systems and controls are designed to provide reasonable but not absolute assurance that the financial records accurately reflect the transactions of the Company, the Company’s assets are safeguarded and that the financial statements present fairly the financial condition and results of operations of the Company.

In the opinion of management, the consolidated balance sheets as of June 30, 2013 and December 31, 2012 and the related consolidated statements of income and consolidated statements of comprehensive income for the three- and six-months ended June 30, 2013 and 2012, and consolidated statements of changes in shareholders’ equity and consolidated statements of cash flows for the six months ended June 30, 2013 and 2012 present fairly the financial condition and results of operations of the Company. All material adjustments required for a fair presentation have been made. These adjustments are of a normal recurring nature. Certain reclassifications have been made to the 2012 financial statements to conform to the 2013 presentation.

This Quarterly Report on Form 10-Q should be read in conjunction with the Company's audited financial statements for the year ended December 31, 2012, and the notes included therein, included within the Company's Annual Report filed on Form 10-K.

Critical accounting policies

The presentation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect many of the reported amounts and disclosures. Actual results could differ from these estimates.

A material estimate that is particularly susceptible to significant change relates to the determination of the allowance for loan losses. Management believes that the allowance for loan losses at June 30, 2013 is adequate and reasonable. Given the subjective nature of identifying and valuing loan losses, it is likely that well-informed individuals could make different assumptions and could, therefore, calculate a materially different allowance value. While management uses available information to recognize losses on loans, changes in economic conditions may necessitate revisions in the future. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Company's allowance for loan losses. Such agencies may require the Company to recognize adjustments to the allowance based on their judgment of information available to them at the time of their examination.

Another material estimate is the calculation of fair values of the Company's investment securities. Except for the Company's investment in corporate bonds, consisting of pooled trust preferred securities, fair values of the other investment securities are determined by pricing provided by a third-party vendor, who is a provider of financial market data, analytics and related services to financial institutions. For the Company's investment in pooled trust preferred securities, management is unable to obtain readily attainable and realistic pricing from market traders due to a lack of active market participants and therefore management has determined the market for these securities to be inactive. In order to determine the fair value of the pooled trust preferred securities, management relied on the use of an income valuation approach (present value technique) that maximizes the use of relevant observable inputs and minimizes the use of unobservable inputs, the results of which are more representative of fair value than the market approach valuation technique used for the other investment securities.

Based on experience, management is aware that estimated fair values of investment securities tend to vary among valuation services. Accordingly, when selling investment securities, price quotes may be obtained from more than one source. The majority of the Company's investment securities are classified as available-for-sale (AFS). AFS securities are carried at fair value on the consolidated balance sheets, with unrealized gains and losses, net of income tax, reported separately within shareholders' equity as a component of accumulated other comprehensive income (loss) (OCI).

The fair value of residential mortgage loans, classified as held-for-sale (HFS), is obtained from the Federal National Mortgage Association (FNMA) or the Federal Home Loan Bank (FHLB). Generally, the market to which the Company sells residential mortgages it originates for sale is restricted and price quotes from other sources are not typically obtained. On occasion, the Company may transfer loans from the loan portfolio to loans HFS. Under these circumstances, pricing may be obtained from other entities and the loans are transferred at the lower of cost or market value and simultaneously sold. As of June 30, 2013 and December 31, 2012, loans classified as HFS consisted of residential mortgage loans.

During the first quarter of 2013, the Company commenced its automobile leasing operations, a component of auto loans and leases in the consumer segment of the loan portfolio. Financing of automobiles, provided to customers under lease arrangements of varying terms, are accounted for as direct finance leases. Interest on automobile direct finance leasing is determined using the interest method. Generally, the interest method is used to arrive at a level effective yield over the life of the lease.

Foreclosed assets held-for-sale includes other real estate acquired through foreclosure (ORE) and may, from time-to-time, include repossessed assets such as automobiles. ORE is carried at the lower of cost (principal balance at date of foreclosure) or fair value less estimated cost to sell. Any write-downs at the date of foreclosure or within a reasonable period of time after foreclosure are charged to the allowance for loan losses. Expenses incurred to maintain ORE properties, subsequent write downs to the asset's fair value and gains or losses on disposal are included as components of other real estate owned expense in the consolidated statements of income.

For purposes of the consolidated statements of cash flows, cash and cash equivalents includes cash on hand, amounts due from banks and interest-bearing deposits with financial institutions. For the six months ended June 30, 2013 and 2012, the Company paid interest of $1.5 million and $1.8 million, respectively. The Company was required to pay income taxes of $0.9 million and $1.2 million during the first six months of 2013 and 2012, respectively. Transfers from loans to foreclosed assets held-for-sale amounted to $1.4 million and $1.2 million during the six months ended June 30, 2013 and 2012. During the same respective periods, transfers from loans to loans HFS amounted to $2.7 million and $2.0 million. Expenditures for construction in process, a component of other assets in the consolidated balance sheets, are included in acquisition of bank premises and equipment.

2. New Accounting Pronouncements

In February 2013, the Financial Accounting Standards Board (FASB) issued the accounting update related to; Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income. The update requires entities to present information about reclassification adjustments from accumulated other comprehensive income in their annual financial statements in a single note or on the face of the financial statements. The new requirement is effective prospectively for interim and annual reporting periods beginning after December 15, 2012. The provisions of this accounting update require expanded financial reporting disclosures.

3. Accumulated other comprehensive income (loss)

The following tables illustrate the changes in accumulated other comprehensive income (loss) by component and the details about the components of accumulated comprehensive income (loss) as of and for the periods indicated:

As of and for the six months ended June 30, 2013

(dollars in thousands)	Unrealized gains on available-for-sale securities	Non-credit-related impairment losses on investment securities	Total
Beginning balance	$ 1,905	$ (1,669)	$ 236
Other comprehensive (loss) income before reclassifications	(1,469)	35	(1,434)
Amounts reclassified from accumulated other comprehensive income	(85)	-	(85)
Net current-period other comprehensive (loss) income	(1,554)	35	(1,519)
Ending balance	$ 351	$ (1,634)	$ (1,283)

As of and for the three months ended June 30, 2013

(dollars in thousands)	Unrealized gains on available-for-sale securities	Non-credit-related impairment losses on investment securities	Total
Beginning balance	$ 1,551	$ (1,695)	$ (144)
Other comprehensive (loss) income before reclassifications	(1,194)	61	(1,133)
Amounts reclassified from accumulated other comprehensive income	(6)	-	(6)
Net current-period other comprehensive (loss) income	(1,200)	61	(1,139)
Ending balance	$ 351	$ (1,634)	$ (1,283)

In the tables above, all amounts are net of tax at 34%. Amounts in parentheses indicate debits.

Details about accumulated other comprehensive income components (dollars in thousands)	Amount reclassified from accumulated other comprehensive income		Affected line item in the statement where net income is presented
For the six months ended June 30, 2013			
Unrealized gains on AFS securities	$	128	Gain on sale, recovery, or disposal of investment securities
		-	Net impairment losses on investment securities
		128	Income before income taxes
		(43)	Provision for income taxes
Total reclassifications for the period	$	85	Net income
For the three months ended June 30, 2013			
Unrealized gains on AFS securities	$	9	Gain on sale, recovery, or disposal of investment securities
		-	Net impairment losses on investment securities
		9	Income before income taxes
		(3)	Provision for income taxes
Total reclassifications for the period	$	6	Net income

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4. Investment securities

The amortized cost and fair value of investment securities at June 30, 2013 and December 31, 2012 are summarized as follows:

(dollars in thousands)	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
June 30, 2013				
Held-to-maturity securities:				
MBS - GSE residential	$ 207	$ 20	$ -	$ 227
Available-for-sale securities:				
Agency - GSE	$ 13,168	$ 35	$ 25	$ 13,178
Obligations of states and political subdivisions	31,726	1,231	416	32,541
Corporate bonds:				
Pooled trust preferred securities	6,203	222	4,302	2,123
MBS - GSE residential	46,812	1,301	192	47,921
Total debt securities	97,909	2,789	4,935	95,763
Equity securities - financial services	295	201	-	496
Total available-for-sale securities	$ 98,204	$ 2,990	$ 4,935	$ 96,259

(dollars in thousands)	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
December 31, 2012				
Held-to-maturity securities:				
MBS - GSE residential	$ 289	$ 31	$ -	$ 320
Available-for-sale securities:				
Agency - GSE	$ 17,651	$ 102	$ 13	$ 17,740
Obligations of states and political subdivisions	26,979	2,879	1	29,857
Corporate bonds:				

Pooled trust preferred securities	6,323	185	4,683	1,825
MBS - GSE residential	48,836	1,761	44	50,553
Total debt securities	99,789	4,927	4,741	99,975
Equity securities - financial services	295	171	-	466
Total available-for-sale securities	$ 100,084	$ 5,098	$ 4,741	$ 100,441

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The amortized cost and fair value of debt securities at June 30, 2013 by contractual maturity are summarized below:

(dollars in thousands)	Amortized cost	Fair value
Held-to-maturity securities:		
MBS - GSE residential	$ 207	$ 227
Available-for-sale securities:		
Debt securities:		
Due in one year or less	$ 2,864	$ 2,873
Due after one year through five years	10,150	10,152
Due after five years through ten years	2,994	3,104
Due after ten years	35,089	31,713
Total debt securities	51,097	47,842
MBS - GSE residential	46,812	47,921
Total available-for-sale debt securities	$ 97,909	$ 95,763

Actual maturities will differ from contractual maturities because issuers and borrowers may have the right to call or repay obligations with or without call or prepayment penalty. Agency – GSE and municipal securities are included based on their original stated maturity. MBS – GSE residential, which are based on weighted-average lives and subject to monthly principal pay-downs, are listed in total.

The following table presents the fair value and gross unrealized losses of investment securities aggregated by investment type, the length of time and the number of securities that have been in a continuous unrealized loss position as of June 30, 2013 and December 31, 2012:

	Less than 12 months		More than 12 months		Total	
(dollars in thousands)	Fair value	Unrealized losses	Fair value	Unrealized losses	Fair value	Unrealized losses
June 30, 2013						
Agency - GSE	$ 3,081	$ 25	$ -	$ -	$ 3,081	$ 25
Obligations of states and political subdivisions	8,361	416	-	-	8,361	416
Corporate bonds:						
Pooled trust preferred securities	-	-	1,490	4,302	1,490	4,302
MBS - GSE residential	11,764	192	-	-	11,764	192
Total temporarily impaired securities	$ 23,206	$ 633	$ 1,490	$ 4,302	$ 24,696	$ 4,935

Number of securities		26				7				33		
December 31, 2012												
Agency - GSE	$	1,017	$	13	$	-	$	-	$	1,017	$	13
Obligations of states and political subdivisions		281		1		-		-		281		1
Corporate bonds:												
Pooled trust preferred securities		-		-		1,639		4,683		1,639		4,683
MBS - GSE residential		6,214		44		-		-		6,214		44
Total temporarily impaired securities	$	7,512	$	58	$	1,639	$	4,683	$	9,151	$	4,741
Number of securities		5				8				13		

Most of the securities in the investment portfolio have fixed rates or have predetermined scheduled rate changes, and many have call features that allow the issuer to call the security at par before its stated maturity, without penalty. Management believes the cause of the unrealized losses is related to changes in interest rates, instability in the capital markets or the limited trading activity due to illiquid conditions in the debt market and is not directly related to credit quality.

Management conducts a formal review of investment securities on a quarterly basis for the presence of other-than-temporary impairment (OTTI). The accounting guidance related to OTTI requires the Company to assess whether OTTI is present when the fair value of a debt security is less than its amortized cost as of the balance sheet date. Under those circumstances, OTTI is considered to have occurred if: (1) the entity has intent to sell the security; (2) more likely than not the entity will be required to sell the security before recovery of its amortized cost basis; or (3) the present value of expected cash flows is not sufficient to recover the entire amortized cost.

The accounting guidance requires that credit-related OTTI be recognized in earnings while non-credit-related OTTI on securities not expected to be sold be recognized in other comprehensive income (loss) (OCI). Non-credit-related OTTI is based on other factors affecting market value, including illiquidity. Presentation of OTTI is made in the consolidated statements of income on a gross basis with an offset for the amount of non-credit-related OTTI recognized in OCI.

The Company’s OTTI evaluation process also follows the guidance set forth in topics related to debt and equity securities. The guidance set forth in the pronouncements require the Company to take into consideration current market conditions, fair value in relationship to cost, extent and nature of changes in fair value, issuer rating changes and trends, volatility of earnings, current analysts’ evaluations, all available information relevant to the collectability of debt securities, the ability and intent to hold investments until a recovery of fair value which may be to maturity and other factors when evaluating for the existence of OTTI. The guidance requires that credit-related OTTI be recognized as a realized loss through earnings when there has been an adverse change in the holder’s expected cash flows such that the full amount (principal and interest) will probably not be received. This requirement is consistent with the impairment model in the guidance for accounting for debt and equity securities.

For all security types, as of June 30, 2013, the Company applied the criteria provided in the recognition and presentation guidance related to OTTI. That is, management has no intent to sell the securities and no conditions were identified by management that more likely than not would require the Company to sell the securities before recovery of their amortized cost basis. The results indicated there was no presence of OTTI in the Company’s portfolios of Agency – Government Sponsored Enterprise (GSE), Mortgage-backed securities (MBS) – GSE residential and Obligations of states and political subdivisions. Following is a description of the security types within the Company’s investment portfolio.

Agency - GSE and MBS - GSE residential

Agency – GSE and MBS – GSE residential securities consist of short- and medium-term notes issued by Federal Home Loan Mortgage Corporation (FHLMC), Federal National Mortgage Association (FNMA), Federal Home Loan Bank (FHLB), Federal Farm Credit Bank (FFCB) and Government National Mortgage Association (GNMA). These securities have interest rates that are fixed and adjustable, have varying short- to mid-term maturity dates and have contractual cash flows guaranteed by the U.S. government or agencies of the U.S. government.

Obligations of states and political subdivisions

The municipal securities are bank qualified or bank eligible, general obligation and revenue bonds rated as investment grade by various credit rating agencies and have fixed rates of interest with mid- to long-term maturities. Fair values of these securities are highly driven by interest rates. Management performs ongoing credit quality reviews on these issues.

In the above security types, management believes the change in fair value is attributable to changes in interest rates and those instruments with unrealized losses were not caused by deterioration of credit quality. Accordingly, as of

June 30, 2013, recognition of OTTI on these securities was unnecessary.

Pooled trust preferred securities

A Pooled Trust Preferred Collateralized Debt Obligation (CDO) is a type of investment security collateralized by trust preferred securities (TPS) issued by banks, insurance companies and real estate investment trusts. The primary collateral type is a TPS issued by a bank. A TPS is a hybrid security that consists of both debt and equity characteristics which includes the ability of the issuer to voluntarily defer interest payments for up to 20 consecutive quarters. A TPS is considered a junior security in the capital structure of the issuer.

There are various investment classes or tranches issued by the CDO. The most senior tranche has the lowest yield but the most protection from credit losses. Conversely, the most junior tranche has the highest yield but the most exposure to risk of credit loss. Junior tranches are subordinate to senior tranches and losses are generally allocated from the lowest tranche with the equity component holding the most risk of credit loss and then subordinate tranches in reverse order up to the most senior tranche. The allocation of losses is defined in the indenture when the CDO was formed.

Unrealized losses in the pooled trust preferred securities (PreTSLs) are caused mainly by: (1) collateral deterioration due to bank failures and credit concerns across the banking sector; (2) widening of credit spreads and (3) illiquidity in the market. The Company’s review of its portfolio of pooled trust preferred securities determined that in 2012 credit-related OTTI be recorded on two holdings, both of which are contained in the Company’s AFS securities portfolio, from credit quality downgrades on the underlying collateral, including the collateral of four banks deferring interest payments within these two securities and one bank fully redeeming which removes all future earnings cash flow. There was no credit related OTTI required to be recognized during the three or six months ended June 30, 2013.

The following table summarizes the amount of OTTI recognized in earnings, by security during the periods indicated:

	Three months ended June 30,		Six months ended June 30,	
(dollars in thousands)	2013	2012	2013	2012
Pooled trust preferred securities:				
PreTSL IX, B1, B3	$ -	$ -	$ -	$ 18
PreTSL XVIII, C	-	31	-	118
Total	$ -	$ 31	$ -	$ 136

The following is a tabular roll-forward of the cumulative amount of credit-related OTTI recognized in earnings:

	Six months ended June 30, 2013		
(dollars in thousands)	HTM	AFS	Total
Beginning balance of credit-related OTTI	$ -	$ (15,416)	$ (15,416)
Additions for credit-related OTTI not previously recognized	-	-	-
Additional credit-related OTTI previously recognized when there is no intent to sell before recovery of amortized cost basis	-	-	-
Ending balance of credit-related OTTI	$ -	$ (15,416)	$ (15,416)

To determine credit-related OTTI, the Company analyzes the collateral of each individual tranche within each of the 13 individual pools in the Company's portfolio of PreTSLs. The Company engaged a third party structured finance firm to: review the underlying collateral of each PreTSL; research trustee reports to update relevant data and credit ratings of the underlying collateral; project default rates and cash flows of the collateral and simulate 10,000 Monte Carlo time-to-default scenarios, performed quarterly, to arrive at the single best estimate of future cash flow for each tranche.

The sub-topics of the Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 320 provide the scope, steps and accounting guidance for impairment: 1) determine whether an investment is impaired; 2) evaluate whether impairment is other-than-temporary; then 3) recognition of OTTI. The guidance in ASC 320 retains and emphasizes the objective of OTTI assessment and the related disclosure requirements by aligning the OTTI methodology for certain securitizations. ASC 325 provides a scope exception for investments that were considered of high credit quality (i.e. rated “AA” or higher) at the time of acquisition. The application of the guidance contained in ASC 320 is used for two investments considered of high credit quality and ASC 325 is used for the remaining eleven securities. In summary, the quarterly evaluations indicated there was no significant adverse change in cash flows in the securities. As a result, there was no credit related OTTI recorded during the three- and six- months ended June 30, 2013.

The guidance prescribed in ASC 320 is used for investments that, upon purchase, were rated of high credit quality, “AA” or higher, by a nationally recognized statistical rating organization. The Company has two PreTSLs (XXIV and XXVII) that were of high credit quality, “AA” rated, upon acquisition. PreTSL XXVII evaluation proved a high probability that the Company will be able to collect all amounts due, both principal and interest, by maturity and thus, determined the impairment is temporary. PreTSL XXIV was evaluated under ASC 320 to determine if the Company expects to recover the remaining amortized cost basis and whether OTTI is deemed to have occurred. An adverse change or short-fall in the expected cash flows compared to the amortized cost would be recorded as credit-related OTTI. To assess the likelihood of recoverability, the present value of the best estimate of future cash flows is compared to the amortized cost. In this situation, the discount rate used was the interest rate implicit in the security at the date of acquisition. The application of the guidance on this security did not result in an adverse change in cash flows when compared to the previous measurement date and therefore, no credit related OTTI has been recorded during 2013.

The remaining eleven PreTSLs were rated “A” by a nationally recognized statistical rating organization at the date of acquisition and as such are considered beneficial interests of securitized financial assets. For these securities, the Company applies the guidance of ASC 325. Under this and other relevant guidance, if the fair value is below amortized cost and the present value of the best estimate of future cash flows declines significantly, evidencing a probable material adverse change in cash flows since the previous measurement date, credit-related OTTI is deemed to exist and written down to the determined present value through a charge to current earnings. The discount rate used under ASC 325 is the yield to accrete beneficial interest, which is representative of the resulting interest from the total gross estimated future cash flows less the current amortized cost. In applying this guidance to the remaining securities, none of the securities measured an adverse change in cash flows and therefore no credit related OTTI has been recorded during 2013.

The following table is the composition of the Company's non-accrual PreTSL securities as of the period indicated:

(dollars in thousands)		June 30, 2013		December 31, 2012	
Deal	Class	Book value	Fair value	Book value	Fair value
Pre TSL V	Mezzanine	$ -	$ 25	$ -	$ 27
Pre TSL VII	Mezzanine	-	126	-	125
Pre TSL IX	B-1,B-3	1,469	569	1,507	630
Pre TSL XI	B-3	985	302	1,053	305
Pre TSL XV	B-1	-	44	-	33
Pre TSL XVIII	C	167	-	167	-
Pre TSL XIX	C	316	5	316	-
Pre TSL XXIV	B-1	407	18	407	12
		$ 3,344	$ 1,089	$ 3,450	$ 1,132

Non-accrual securities have experienced impairment of principal, and interest was "paid-in-kind". When these two conditions exist, the security is placed on non-accrual status. Quarterly, each of the other PreTSL issues is evaluated for the presence of these two conditions and if necessary placed on non-accrual status.

The following table provides additional information with respect to the Company's pooled trust preferred securities as of June 30, 2013:

(dollars in thousands)

Deal	Class	Book value	Fair value	Unrealized gain (loss)	Moody's / Fitch ratings (1)	Current number of banks / insurance companies	Actual deferrals and defaults	Actual deferrals and defaults as a % of current collateral	Excess subordination	Excess subordination (2) as a % of current performing collateral	Effective subordination (3) as a % of current performing collateral
Pre TSL IV	Mezzanine	$ 412	$ 439	$ 27	Caa2 / CCC	6 / -	$ 12,000	18.0	$ 16,415	28.3	39.6
	Mezzanine	-	25	25	C / D	3 / -	28,950	100.0	None	N/A	N/A

Pre TSL V											
Pre TSL VII	Mezzanine	-	126	126	Ca / C	15 / -	85,000	52.8	None	N/A	N/A
Pre TSL IX	B-1,B-3	1,469	569	(900)	Ca / C	46 / -	101,280	27.0	None	N/A	4.9
Pre TSL XI	B-3	985	302	(683)	Ca / C	60 / -	167,250	29.8	None	N/A	1.2
Pre TSL XV	B-1	-	44	44	C / C	61 / 7	173,200	30.8	None	N/A	N/A
Pre TSL XVI	C	-	-	-	C / C	47 / 6	241,570	43.4	None	N/A	N/A
Pre TSL XVII	C	-	-	-	C / C	49 / 6	177,390	38.8	None	N/A	N/A
Pre TSL XVIII	C	167	-	(167)	Ca / C	63 / 14	194,140	30.4	None	N/A	N/A
Pre TSL XIX	C	316	5	(311)	C / C	51 / 14	140,150	22.9	None	N/A	1.9
Pre TSL XXIV	B-1	407	18	(389)	Ca / CC	77 / 11	347,500	34.8	None	N/A	15.0
Pre TSL XXV	C-1	-	-	-	C / C	61 / 7	257,000	33.5	None	N/A	1.7
Pre TSL XXVII	B	2,447	595	(1,852)	Caa3 / CC	40 / 7	81,800	26.1	9,559	4.1	27.8
		$ 6,203	$ 2,123	$ (4,080)							

(1) All ratings have been updated through June 30, 2013.

(2) Excess subordination represents the excess (if any) of the amount of performing collateral over the given class of bonds.

(3) Effective subordination represents the estimated percentage of the performing collateral that would need to defer or default at the next payment in order to trigger a loss of principal or interest. This differs from excess subordination in that it considers the effect of excess interest earned on the performing collateral.

For a further discussion on the fair value determination of the Company’s investment in PreTSLs and other financial instruments, see Note 8, “Fair value measurements”.

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5. Loans and leases

The classifications of loans and leases at June 30, 2013 and December 31, 2012 are summarized as follows:

(dollars in thousands)	June 30, 2013	December 31, 2012
Commercial and industrial	$ 71,352	$ 65,110
Commercial real estate:		
Non-owner occupied	90,303	81,998
Owner occupied	79,547	80,509
Construction	10,207	10,679
Consumer:		
Home equity installment	34,823	32,828
Home equity line of credit	34,280	34,169
Auto loans and leases	19,202	17,411
Other	5,360	6,139
Residential:		
Real estate	105,675	96,765
Construction	9,253	7,948
Total	460,002	433,556
Less:		
Allowance for loan losses	(8,296)	(8,972)
Unearned lease revenue	(41)	-
Loans and leases, net	$ 451,665	$ 424,584

Net deferred loan costs of $1.0 million have been added to the carrying values of loans at June 30, 2013 and December 31, 2012, respectively.

The Company services real estate loans for investors in the secondary mortgage market which are not included in the accompanying consolidated balance sheets. The approximate amount of mortgages serviced amounted to $229.4 million as of June 30, 2013 and $214.7 million as of December 31, 2012.

The Company utilizes an external independent loan review firm that reviews and validates the credit risk program on at least an annual basis. Results of these reviews are presented to management and the Board of Directors. The loan review process complements and reinforces the risk identification and assessment decisions made by lenders and credit personnel, as well as the Company's policies and procedures.

Non-accrual loans

The decision to place loans on non-accrual status is made on an individual basis after considering factors pertaining to each specific loan. Commercial and industrial and commercial real estate loans are placed on non-accrual status when management has determined that payment of all contractual principal and interest is in doubt or the loan is past due 90 days or more as to principal and interest, unless well-secured and in the process of collection. Consumer loans secured by real estate and residential mortgage loans are placed on non-accrual status at 120 days past due as to principal and interest and unsecured consumer loans are charged off when the loan is 90 days or more past due as to principal and interest. The Company considers all non-accrual loans to be impaired loans.

Non-accrual loans, segregated by class, at June 30, 2013 and December 31, 2012, were as follows:

(dollars in thousands)	June 30, 2013	December 31, 2012
Commercial and industrial	$ 9	$ 18
Commercial real estate:		
Non-owner occupied	1,698	1,884
Owner occupied	1,488	5,031
Construction	857	1,123
Consumer:		
Home equity installment	778	1,306
Home equity line of credit	334	381
Other	32	48
Residential:		
Real estate	1,514	2,330
Total	$ 6,710	$ 12,121

Troubled Debt Restructuring

A modification of a loan constitutes a troubled debt restructuring (TDR) when a borrower is experiencing financial difficulty and the modification constitutes a concession. The Company considers all TDRs to be impaired loans. The Company offers various types of concessions when modifying a loan, however, forgiveness of principal is rarely granted. Commercial and industrial loans modified in a TDR often involve temporary interest-only payments, term extensions, and converting revolving credit lines to term loans. Additional collateral, a co-borrower, or a guarantor is often requested. Commercial real estate and construction loans modified in a TDR often involve reducing the interest rate for the remaining term of the loan, extending the maturity date at an interest rate lower than the current market rate for new debt with similar risk, or substituting or adding a new borrower or guarantor. Construction loans modified in a TDR may also involve extending the interest-only payment period. Residential mortgage loans modified in a TDR are primarily comprised of loans where monthly payments are lowered to accommodate the borrowers' financial needs for an extended period of time. After the lowered monthly payment period ends, the borrower would revert back to paying principal and interest per the original terms with the maturity date adjusted accordingly. Home equity and automobile loan modifications are typically not granted and therefore standard modification terms do not exist for loans of this type.

Loans modified in a TDR may or may not be placed on non-accrual status. As of June 30, 2013, total TDRs amounted to $2.1 million, of which $1.0 million were on non-accrual status. This was a slight reduction from the December 31, 2012 total of $2.2 million of which $1.1 million were on non-accrual status.

Loans modified in a TDR are closely monitored for delinquency as an early indicator of possible future default. If loans modified in a TDR subsequently default, the Company evaluates the loan for possible further impairment. There were no loans modified in a TDR during the three- and six-months ended June 30, 2013. There were no loans modified in a TDR during the twelve months ended June 30, 2013 that subsequently defaulted during the three- or six months ended June 30, 2013.

The allowance may be increased, adjustments may be made in the allocation of the allowance or partial charge offs may be taken to further write-down the carrying value of the loan. An allowance for impaired loans that have been modified in a TDR is measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or the loan's observable market price. If the loan is collateral dependent, the estimated fair value of the collateral, less any selling costs, is used to establish the allowance.

Past due loans

Loans are considered past due when the contractual principal and/or interest are not received by the due date. An aging analysis of past due loans, segregated by class of loans, as of the period indicated is as follows (dollars in thousands):