

C & F FINANCIAL CORP  
Form 10-Q  
November 08, 2012

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

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FORM 10-Q

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(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2012

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: 000-23423

C&F Financial Corporation  
(Exact name of registrant as specified in its charter)

Virginia  
(State or other jurisdiction of incorporation or organization)

54-1680165  
(I.R.S. Employer Identification No.)

802 Main Street West Point, VA  
(Address of principal executive offices)

23181  
(Zip Code)

(804) 843-2360  
(Registrant's telephone number, including area code)

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

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Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.  Yes

No

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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  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.

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

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

At November 1, 2012, the latest practicable date for determination, 3,233,059 shares of common stock, \$1.00 par value, of the registrant were outstanding.

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## PART I - FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

CONSOLIDATED BALANCE SHEETS  
(In thousands, except for share and per share amounts)

	September 30, 2012 (Unaudited)	December 31, 2011
<b>ASSETS</b>		
Cash and due from banks	\$6,100	\$ 5,787
Interest-bearing deposits in other banks	7,649	4,723
Federal funds sold	—	997
Total cash and cash equivalents	13,749	11,507
Securities-available for sale at fair value, amortized cost of \$131,438 and \$137,575, respectively	140,608	144,646
Loans held for sale, net	78,072	70,062
Loans, net of allowance for loan losses of \$34,990 and \$33,677, respectively	646,236	616,984
Federal Home Loan Bank stock, at cost	3,744	3,767
Corporate premises and equipment, net	27,627	28,462
Other real estate owned, net of valuation allowance of \$4,547 and \$3,927, respectively	4,621	6,059
Accrued interest receivable	5,594	5,242
Goodwill	10,724	10,724
Other assets	30,844	30,671
Total assets	\$961,819	\$ 928,124
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>Deposits</b>		
Noninterest-bearing demand deposits	\$ 116,636	\$ 95,556
Savings and interest-bearing demand deposits	254,976	242,917
Time deposits	292,600	307,943
Total deposits	664,212	646,416
Short-term borrowings	17,371	7,544
Long-term borrowings	132,987	132,987
Trust preferred capital notes	20,620	20,620
Accrued interest payable	921	1,111
Other liabilities	27,231	23,356
Total liabilities	863,342	832,034
<b>Shareholders' equity</b>		
Preferred stock (\$1.00 par value, 3,000,000 shares authorized, 0 and 10,000 shares issued and outstanding, respectively)	—	10
Common stock (\$1.00 par value, 8,000,000 shares authorized, 3,227,311 and 3,178,510 shares issued and outstanding, respectively)	3,134	3,091
Additional paid-in capital	4,861	13,438

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Retained earnings	85,747	76,167
Accumulated other comprehensive income, net	4,735	3,384
Total shareholders' equity	98,477	96,090
Total liabilities and shareholders' equity	\$961,819	\$ 928,124

The accompanying notes are an integral part of the consolidated financial statements.

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## CONSOLIDATED STATEMENTS OF INCOME

(Unaudited)

(In thousands, except for share and per share amounts)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
<b>Interest income</b>				
Interest and fees on loans	\$18,284	\$17,611	\$53,584	\$51,000
Interest on money market investments	2	7	15	38
<b>Interest and dividends on securities</b>				
U.S. government agencies and corporations	49	50	158	156
Tax-exempt obligations of states and political subdivisions	1,141	1,222	3,514	3,641
Corporate bonds and other	29	28	88	84
<b>Total interest income</b>	<b>19,505</b>	<b>18,918</b>	<b>57,359</b>	<b>54,919</b>
<b>Interest expense</b>				
Savings and interest-bearing deposits	184	247	634	853
Certificates of deposit, \$100 or more	452	677	1,639	2,013
Other time deposits	565	785	1,926	2,454
Borrowings	960	975	2,900	2,907
Trust preferred capital notes	250	247	747	736
<b>Total interest expense</b>	<b>2,411</b>	<b>2,931</b>	<b>7,846</b>	<b>8,963</b>
<b>Net interest income</b>	<b>17,094</b>	<b>15,987</b>	<b>49,513</b>	<b>45,956</b>
Provision for loan losses	2,965	4,075	8,550	10,285
<b>Net interest income after provision for loan losses</b>	<b>14,129</b>	<b>11,912</b>	<b>40,963</b>	<b>35,671</b>
<b>Noninterest income</b>				
Gains on sales of loans	6,203	4,282	15,024	11,778
Service charges on deposit accounts	823	915	2,449	2,609
Other service charges and fees	1,685	1,370	4,661	3,776
Net gains on calls of available for sale securities	3	1	11	1
Other income	856	572	2,537	1,550
<b>Total noninterest income</b>	<b>9,570</b>	<b>7,140</b>	<b>24,682</b>	<b>19,714</b>
<b>Noninterest expenses</b>				
Salaries and employee benefits	11,001	7,965	30,339	24,887
Occupancy expenses	1,701	1,644	5,099	4,781
Other expenses	4,285	4,314	11,833	11,932
<b>Total noninterest expenses</b>	<b>16,987</b>	<b>13,923</b>	<b>47,271</b>	<b>41,600</b>
<b>Income before income taxes</b>	<b>6,712</b>	<b>5,129</b>	<b>18,374</b>	<b>13,785</b>
Income tax expense	2,179	1,616	5,880	4,220
<b>Net income</b>	<b>4,533</b>	<b>3,513</b>	<b>12,494</b>	<b>9,565</b>
Effective dividends on preferred stock	—	458	311	1,037

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Net income available to common shareholders	\$4,533	\$3,055	\$12,183	\$8,528
Per common share data				
Net income – basic	\$1.41	\$0.97	\$3.80	\$2.72
Net income – assuming dilution	\$1.36	\$0.96	\$3.69	\$2.69
Cash dividends declared	\$0.27	\$0.25	\$0.79	\$0.75
Weighted average number of shares – basic	3,220,906	3,141,926	3,206,739	3,132,332
Weighted average number of shares – assuming dilution	3,332,970	3,174,369	3,298,030	3,166,930

The accompanying notes are an integral part of the consolidated financial statements.

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CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME  
(Unaudited)  
(In thousands)

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2012	2011	2012	2011
Net income	\$4,533	\$3,513	\$12,494	\$9,565
Other comprehensive income, net:				
Changes in defined benefit plan assets and benefit obligations, net	7	4	19	11
Unrealized loss on cash flow hedging instruments, net	(16 )	(161 )	(32 )	(245 )
Unrealized holding gains on securities, net of reclassification adjustment	459	1,694	1,364	3,840
Comprehensive income, net	\$4,983	\$5,050	\$13,845	\$13,171

The accompanying notes are an integral part of the consolidated financial statements.



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## CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

(Unaudited)

(In thousands, except per share amounts)

	Preferred Stock	Common Stock	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income, Net	Total Shareholders' Equity
Balance December 31, 2011	\$10	\$3,091	\$13,438	\$76,167	\$ 3,384	\$ 96,090
Comprehensive income:						
Net income	—	—	—	12,494	—	12,494
Other comprehensive income, net	—	—	—	—	1,351	1,351
Comprehensive income	—	—	—	—	—	13,845
Stock options exercised	—	36	763	—	—	799
Share-based compensation	—	—	365	—	—	365
Restricted stock vested	—	3	(3 )	—	—	—
Preferred stock redemption	(10 )	—	(9,990 )	—	—	(10,000 )
Accretion of preferred stock discount	—	—	172	(172 )	—	—
Common stock issued	—	4	116	—	—	120
Cash dividends paid – common stock (\$0.79 per share)	—	—	—	(2,539 )	—	(2,539 )
Cash dividends paid – preferred stock (5% per annum)	—	—	—	(203 )	—	(203 )
Balance September 30, 2012	\$—	\$3,134	\$4,861	\$85,747	\$ 4,735	\$ 98,477

	Preferred Stock	Common Stock	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income, Net	Total Shareholders' Equity
Balance December 31, 2010	\$20	\$3,032	\$22,112	\$67,542	\$ 71	\$ 92,777
Comprehensive income:						
Net income	—	—	—	9,565	—	9,565
Other comprehensive income, net	—	—	—	—	3,606	3,606
Comprehensive income	—	—	—	—	—	13,171
Stock options exercised	—	8	134	—	—	142
Share-based compensation	—	—	251	—	—	251
Restricted stock vested	—	5	(5 )	—	—	—
Preferred stock redemption	(10 )	—	(9,990 )	—	—	(10,000 )
Accretion of preferred stock discount	—	—	311	(311 )	—	—
Common stock issued	—	2	1	—	—	3
Cash dividends paid – common stock (\$0.75 per share)	—	—	—	(2,347 )	—	(2,347 )

Cash dividends paid – preferred stock (5% per annum)	—	—	—	(725 )	—	(725 )
Balance September 30, 2011	\$10	\$3,047	\$12,814	\$73,724	\$ 3,677	\$ 93,272

The accompanying notes are an integral part of the consolidated financial statements.

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## CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)  
(In thousands)

	Nine Months Ended September 30,	
	2012	2011
Operating activities:		
Net income	\$ 12,494	\$ 9,565
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	1,690	1,553
Provision for loan losses	8,550	10,285
Provision for indemnifications	955	552
Provision for other real estate owned losses	800	711
Share-based compensation	365	251
Accretion of discounts and amortization of premiums on securities, net	548	581
Net realized gain on calls of securities	(11 )	(1 )
Realized gain on sales of other real estate owned	(54 )	(87 )
Proceeds from sales of loans held for sale	611,449	458,486
Origination of loans held for sale	(619,459 )	(427,710 )
Change in other assets and liabilities:		
Accrued interest receivable	(352 )	(77 )
Other assets	(898 )	(232 )
Accrued interest payable	(190 )	(40 )
Other liabilities	2,896	(4,143 )
Net cash provided by operating activities	18,783	49,694
Investing activities:		
Proceeds from maturities, calls and sales of securities available for sale	28,334	21,768
Purchases of securities available for sale	(22,733 )	(27,958 )
Redemption of Federal Home Loan Bank stock	23	89
Net increase in customer loans	(38,355 )	(30,501 )
Other real estate owned improvements	(205 )	--
Proceeds from sales of other real estate owned	1,450	7,851
Purchases of corporate premises and equipment, net	(855 )	(1,578 )
Net cash used in investing activities	(32,341 )	(30,329 )
Financing activities:		
Net increase in demand, interest-bearing demand and savings deposits	33,139	9,674
Net (decrease) increase in time deposits	(15,343 )	2,558
Net increase (decrease) in borrowings	9,827	(4,716 )
Issuance of common stock	919	145
Redemption of preferred stock	(10,000 )	(10,000 )
Cash dividends	(2,742 )	(3,072 )
Net cash provided by (used in) financing activities	15,800	(5,411 )
Net increase in cash and cash equivalents	2,242	13,954
Cash and cash equivalents at beginning of period	11,507	9,680
Cash and cash equivalents at end of period	\$ 13,749	\$ 23,634

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Supplemental disclosure		
Interest paid	\$ 8,036	\$ 9,003
Income taxes paid	6,536	5,658
Supplemental disclosure of noncash investing and financing activities		
Unrealized gains on securities available for sale	\$ 2,099	\$ 5,908
Loans transferred to other real estate owned	553	4,039
Pension adjustment	27	16
Unrealized loss on cash flow hedging instrument	(51 )	(398 )

The accompanying notes are an integral part of the consolidated financial statements.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

NOTE 1: Summary of Significant Accounting Policies

**Principles of Consolidation:** The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP) for interim financial reporting and with applicable quarterly reporting regulations of the Securities and Exchange Commission (the SEC). They do not include all of the information and notes required by U.S. GAAP for complete financial statements. Therefore, these consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the C&F Financial Corporation Annual Report on Form 10-K for the year ended December 31, 2011.

The unaudited consolidated financial statements include the accounts of C&F Financial Corporation (the Corporation) and its wholly-owned subsidiary, Citizens and Farmers Bank (the Bank or C&F Bank). All significant intercompany accounts and transactions have been eliminated in consolidation. In addition, C&F Financial Corporation owns C&F Financial Statutory Trust I and C&F Financial Statutory Trust II, which are unconsolidated subsidiaries. The subordinated debt owed to these trusts is reported as a liability of the Corporation.

**Nature of Operations:** The Corporation is a bank holding company incorporated under the laws of the Commonwealth of Virginia. The Corporation owns all of the stock of its subsidiary, C&F Bank, which is an independent commercial bank chartered under the laws of the Commonwealth of Virginia. The Bank and its subsidiaries offer a wide range of banking and related financial services to both individuals and businesses.

The Bank has five wholly-owned subsidiaries: C&F Mortgage Corporation and Subsidiaries (C&F Mortgage), C&F Finance Company (C&F Finance), C&F Title Agency, Inc., C&F Investment Services, Inc. and C&F Insurance Services, Inc., all incorporated under the laws of the Commonwealth of Virginia. C&F Mortgage, organized in September 1995, was formed to originate and sell residential mortgages and through its subsidiaries, Hometown Settlement Services LLC and Certified Appraisals LLC, provides ancillary mortgage loan production services, such as loan settlements, title searches and residential appraisals. C&F Finance, acquired on September 1, 2002, is a regional finance company providing automobile loans. C&F Title Agency, Inc., organized in October 1992, primarily sells title insurance to the mortgage loan customers of the Bank and C&F Mortgage. C&F Investment Services, Inc., organized in April 1995, is a full-service brokerage firm offering a comprehensive range of investment services. C&F Insurance Services, Inc., organized in July 1999, owns an equity interest in an insurance agency that sells insurance products to customers of the Bank, C&F Mortgage and other financial institutions that have an equity interest in the agency. Business segment data is presented in Note 8.

**Basis of Presentation:** The preparation of financial statements in conformity with U.S. 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 reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, the allowance for indemnifications, impairment of loans, impairment of securities, the valuation of other real estate owned, the projected benefit obligation under the defined benefit pension plan, the valuation of deferred taxes, the valuation of derivative financial instruments and goodwill impairment. In the opinion of management, all adjustments, consisting only of normal recurring adjustments, which are necessary for a fair presentation of the results of operations in these financial statements, have been made. Certain reclassifications have been made to prior period amounts to conform to the current period presentation.

Derivative Financial Instruments: The Corporation recognizes derivative financial instruments at fair value as either an other asset or other liability in the consolidated balance sheets. The derivative financial instruments have been designated as and qualify as cash flow hedges. The effective portion of the gain or loss on cash flow hedges is reported as a component of other comprehensive income, net of deferred income taxes, and reclassified into earnings in the same period or periods during which the hedged transaction affects earnings.

Share-Based Compensation: Compensation expense for the third quarter and first nine months of 2012 included net expense of \$123,000 (\$76,000 after tax) and \$365,000 (\$226,000 after tax), respectively, for restricted stock granted since 2007. As of September 30, 2012, there was \$1.23 million of total unrecognized compensation expense related to unvested restricted stock that will be recognized over the remaining requisite service periods.

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A summary of activity for restricted stock awards during the first nine months of 2012 is presented below:

	Shares	Weighted-Average Grant Date Fair Value
Unvested, January 1, 2012	87,125	\$ 22.59
Granted	11,775	\$ 29.81
Vested	(3,650 )	\$ 19.82
Cancelled	(2,050 )	\$ 22.70
Unvested, September 30, 2012	93,200	\$ 23.60

Stock option activity during the nine months ended September 30, 2012 and stock options outstanding at September 30, 2012 are summarized below:

	Shares	Exercise Price*	Remaining Contractual Life (in years)*	Intrinsic Value of Unexercised In-The Money Options (in 000's)
Options outstanding at January 1, 2012	325,067	\$36.68	3.0	
Exercised	(35,235 )	22.69		
Options outstanding and exercisable at September 30, 2012	289,832	\$38.38	2.5	\$ 454

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\* Weighted average

## Recent Significant Accounting Pronouncements:

In April 2011, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2011-03, Transfers and Servicing – Reconsideration of Effective Control for Repurchase Agreements. The amendments in this ASU remove from the assessment of effective control (1) the criterion requiring the transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed terms, even in the event of default by the transferee and (2) the collateral maintenance implementation guidance related to that criterion. The amendments in this ASU are effective for the first interim or annual period beginning on or after December 15, 2011. The guidance should be applied prospectively to transactions or modifications of existing transactions that occur on or after the effective date. Early adoption was not permitted. The adoption of the new guidance did not have a material effect on the Corporation's financial statements.

In May 2011, the FASB issued ASU 2011-04, Fair Value Measurement – Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs. This ASU is the result of joint efforts by the FASB and the International Accounting Standards Board to develop a single, converged fair value framework on how (not when) to measure fair value and what disclosures to provide about fair value measurements. The ASU is largely consistent with existing fair value measurement principles in U.S. GAAP (Topic 820), with many of the amendments made to eliminate unnecessary wording differences between U.S. GAAP and International Financial Reporting Standards. The amendments are effective for interim and annual periods beginning after December 15, 2011 with prospective application. Early application was not permitted. The Corporation has included the required

disclosures in its consolidated financial statements.

In June 2011, the FASB issued ASU 2011-05, Comprehensive Income – Presentation of Comprehensive Income. The objective of this ASU is to improve the comparability, consistency and transparency of financial reporting and to increase the prominence of items reported in other comprehensive income by eliminating the option to present components of other comprehensive income as part of the statement of changes in stockholders' equity. The amendments require that all non-owner changes in stockholders' equity be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The amendments do not change the items that must be reported in other comprehensive income, the option for an entity to present components of other comprehensive income either net of related tax effects or before related tax effects, or the calculation or reporting of earnings per share. The amendments in this ASU should be applied retrospectively. The amendments are effective for fiscal years and interim periods within those years beginning after December 15, 2011. The amendments do not require transition disclosures. The Corporation has included the required disclosures in its consolidated financial statements.

In September 2011, the FASB issued ASU 2011-08, Intangible – Goodwill and Other – Testing Goodwill for Impairment. The amendments in this ASU permit an entity to first assess qualitative factors related to goodwill to determine whether it is more likely than not that the fair value of the reporting unit is less than its carrying amount as a basis for determining whether it is necessary to



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perform the two-step goodwill test described in Topic 350. The more-likely-than-not threshold is defined as having a likelihood of more than 50 percent. Under the amendments in this ASU, an entity is not required to calculate the fair value of a reporting unit unless the entity determines that it is more likely than not that its fair value is less than its carrying amount. The amendments in this ASU are effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. Early adoption is permitted, including for annual and interim goodwill impairment tests performed as of a date before September 15, 2011, if an entity's financial statements for the most recent annual or interim period have not yet been issued. The adoption of the new guidance did not have a material effect on the Corporation's consolidated financial statements.

In December 2011, the FASB issued ASU 2011-12, Comprehensive Income - Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in ASU 2011-05. The amendments are being made to allow the FASB time to redeliberate whether to present on the face of the financial statements the effects of reclassifications out of accumulated other comprehensive income on the components of net income and other comprehensive income for all periods presented. While the FASB is considering the operational concerns about the presentation requirements for reclassification adjustments and the needs of financial statement users for additional information about reclassification adjustments, entities should continue to report reclassifications out of accumulated other comprehensive income consistent with the presentation requirements in effect before ASU 2011-05. All other requirements in ASU 2011-05 are not affected by ASU 2011-12, including the requirement to report comprehensive income either in a single continuous financial statement or in two separate but consecutive financial statements. Public entities should apply these requirements for fiscal years, and interim periods within those years, beginning after December 15, 2011. The Corporation has included the required disclosures in its consolidated financial statements.

## NOTE 2: Securities

Debt and equity securities, all of which were classified as available for sale, are summarized as follows:

(Dollars in thousands)	September 30, 2012			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
U.S. government agencies and corporations	\$ 12,713	\$ 22	\$ (5 )	\$ 12,730
Mortgage-backed securities	2,385	79	—	2,464
Obligations of states and political subdivisions	116,313	9,114	(53 )	125,374
Preferred stock	27	15	(2 )	40
	\$ 131,438	\$ 9,230	\$ (60 )	\$ 140,608

(Dollars in thousands)	December 31, 2011			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
U.S. government agencies and corporations	\$ 15,248	\$ 39	\$ (4 )	\$ 15,283
Mortgage-backed securities	2,135	81	—	2,216
Obligations of states and political subdivisions	120,165	6,998	(84 )	127,079
Preferred stock	27	41	—	68

\$ 137,575      \$ 7,159      \$ (88 )      \$ 144,646

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The amortized cost and estimated fair value of securities, all of which were classified as available for sale, at September 30, 2012, by the earlier of contractual maturity or expected maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to prepay obligations with or without call or prepayment penalties.

(Dollars in thousands)	September 30, 2012	
	Amortized Cost	Estimated Fair Value
Due in one year or less	\$ 23,396	\$ 23,573
Due after one year through five years	38,985	40,971
Due after five years through ten years	45,386	49,685
Due after ten years	23,644	26,339
Preferred stock	27	40
	\$ 131,438	\$ 140,608

Proceeds from the maturities, calls and sales of securities available for sale for the nine months ended September 30, 2012 were \$28.33 million.

The Corporation pledges securities primarily as collateral for public deposits and repurchase agreements. Securities with an aggregate amortized cost of \$92.41 million and an aggregate fair value of \$99.82 million were pledged at September 30, 2012. Securities with an aggregate amortized cost of \$106.97 million and an aggregate fair value of \$112.66 million were pledged at December 31, 2011.

Securities in an unrealized loss position at September 30, 2012, by duration of the period of the unrealized loss, are shown below.

(Dollars in thousands)	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
U.S. government agencies and corporations	\$3,320	\$5	\$—	\$—	\$3,320	\$5
Obligations of states and political subdivisions	4,071	51	450	2	4,521	53
Subtotal – debt securities	7,391	56	450	2	7,841	58
Preferred stock	10	2	—	—	10	2
Total temporarily impaired securities	\$7,401	\$58	\$450	\$2	\$7,851	\$60

There are 25 debt securities with fair values totaling \$7.84 million, and one equity security with a fair value of \$10,000 considered temporarily impaired at September 30, 2012. The primary cause of the temporary impairments in the Corporation's investments in debt securities was fluctuations in interest rates. During the third quarter of 2012, the municipal bond sector, which is included in the Corporation's obligations of states and political subdivisions category of securities, experienced rising securities prices as investor demand for municipal bonds continued to be strong given attractive municipal bond yields relative to U.S. Treasuries, and the supply of municipal bonds has been relatively limited. The vast majority of the Corporation's municipal bond portfolio is made up of securities where the issuing municipalities have unlimited taxing authority to support their debt service obligations. At September 30, 2012, approximately 96 percent of the Corporation's obligations of states and political subdivisions, as measured by market value, were rated "A" or better by Standard & Poor's or Moody's Investors Service. Of those in a net unrealized loss position, approximately 87 percent were rated, as measured by market value, "A" or better at September 30, 2012.

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Because the Corporation intends to hold these investments in debt securities to maturity and it is more likely than not that the Corporation will not be required to sell these investments before a recovery of unrealized losses, the Corporation does not consider these investments to be other-than-temporarily impaired at September 30, 2012 and no other-than-temporary impairment has been recognized.

Securities in an unrealized loss position at December 31, 2011, by duration of the period of the unrealized loss, are shown below.

(Dollars in thousands)	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
U.S. government agencies and corporations	\$2,064	\$4	\$—	\$—	\$2,064	\$4
Obligations of states and political subdivisions	3,305	35	1,328	49	4,633	84
Total temporarily impaired securities	\$5,369	\$39	\$1,328	\$49	\$6,697	\$88

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The Corporation's investment in Federal Home Loan Bank (FHLB) stock totaled \$3.74 million at September 30, 2012 and \$3.77 million at December 31, 2011. FHLB stock is generally viewed as a long-term investment and as a restricted investment security, which is carried at cost, because there is no market for the stock, other than the FHLBs or member institutions. Therefore, when evaluating FHLB stock for impairment, its value is based on the ultimate recoverability of the par value rather than by recognizing temporary declines in value. The Corporation does not consider this investment to be other-than-temporarily impaired at September 30, 2012 and no impairment has been recognized. FHLB stock is shown as a separate line item on the balance sheet and is not a part of the available for sale securities portfolio.

## NOTE 3: Loans

Major classifications of loans are summarized as follows:

(Dollars in thousands)	September 30, 2012	December 31, 2011
Real estate – residential mortgage	\$ 148,934	\$ 147,135
Real estate – construction 1	4,628	5,737
Commercial, financial and agricultural 2	216,770	212,235
Equity lines	33,787	33,192
Consumer	6,187	6,057
Consumer finance	270,920	246,305
	681,226	650,661
Less allowance for loan losses	(34,990 )	(33,677 )
Loans, net	\$ 646,236	\$ 616,984

1 Includes the Corporation's real estate construction lending and consumer real estate lot lending.

2 Includes the Corporation's commercial real estate lending, land acquisition and development lending, builder line lending and commercial business lending.

Consumer loans included \$244,000 and \$299,000 of demand deposit overdrafts at September 30, 2012 and December 31, 2011, respectively.

Loans on nonaccrual status were as follows:

(Dollars in thousands)	September 30, 2012	December 31, 2011
Real estate – residential mortgage	\$ 1,101	\$ 2,440
Real estate – construction:		
Construction lending	—	—
Consumer lot lending	—	—
Commercial, financial and agricultural:		
Commercial real estate lending	4,561	5,093
Land acquisition and development lending	7,460	—
Builder line lending	527	2,303
Commercial business lending	736	673
Equity lines	48	123

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Consumer	375	—
Consumer finance	631	381
Total loans on nonaccrual status	\$ 15,439	\$ 11,013

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The past due status of loans as of September 30, 2012 was as follows:

(Dollars in thousands)	30-59 Days Past Due	60-89 Days Past Due	90+ Days Past Due	Total Past Due	Current	Total Loans	90+ Days Past Due and Accruing
Real estate – residential mortgage	\$958	\$1,149	\$ 449	\$2,556	\$146,378	\$148,934	\$ 100
Real estate – construction:							
Construction lending	—	—	—	—	3,249	3,249	—
Consumer lot lending	—	—	—	—	1,379	1,379	—
Commercial, financial and agricultural:							
Commercial real estate lending	476	347	325	1,148	121,943	123,091	237
Land acquisition and development lending	1,844	—	2,031	3,875	33,532	37,407	—
Builder line lending	—	—	—	—	16,035	16,035	—
Commercial business lending	202	40	—	242	39,995	40,237	—
Equity lines	116	92	—	208	33,579	33,787	—
Consumer	4	—	377	381	5,806	6,187	1
Consumer finance	7,048	1,667	631	9,346	261,574	270,920	—
<b>Total</b>	<b>\$10,648</b>	<b>\$3,295</b>	<b>\$ 3,813</b>	<b>\$17,756</b>	<b>\$663,470</b>	<b>\$681,226</b>	<b>\$ 338</b>

For the purposes of the above table, “Current” includes loans that are 1-29 days past due.

The past due status of loans as of December 31, 2011 was as follows:

(Dollars in thousands)	30-59 Days Past Due	60-89 Days Past Due	90+ Days Past Due	Total Past Due	Current	Total Loans	90+ Days Past Due and Accruing
Real estate – residential mortgage	\$1,270	\$1,445	\$ 533	\$3,248	\$143,887	\$147,135	\$ 65
Real estate – construction:							
Construction lending	—	—	—	—	5,084	5,084	—
Consumer lot lending	—	—	—	—	653	653	—

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Commercial, financial and agricultural:							
Commercial real estate lending	986	1,311	—	2,297	114,475	116,772	—
Land acquisition and development lending	—	—	—	—	32,645	32,645	—
Builder line lending	—	—	—	—	17,637	17,637	—
Commercial business lending	480	—	—	480	44,701	45,181	—
Equity lines	69	90	33	192	33,000	33,192	—
Consumer	13	—	—	13	6,044	6,057	3
Consumer finance	5,327	1,041	381	6,749	239,556	246,305	—
Total	\$8,145	\$3,887	\$ 947	\$12,979	\$637,682	\$650,661	\$ 68

For the purposes of the above table, “Current” includes loans that are 1-29 days past due.



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Impaired loans, which included troubled debt restructurings (TDRs) of \$17.85 million, and the related allowance at September 30, 2012, were as follows:

(Dollars in thousands)	Recorded Investment in Loans	Unpaid Principal Balance	Related Allowance	Average Balance-Impaired Loans	Interest Income Recognized
Real estate – residential mortgage	\$ 2,249	\$ 2,294	\$ 438	\$ 2,278	\$ 30
Real estate – construction:					
Construction lending	—	—	—	—	—
Consumer lot lending	—	—	—	—	—
Commercial, financial and agricultural:					
Commercial real estate lending	8,710	8,982	1,737	9,159	62
Land acquisition and development lending	7,460	7,860	1,732	8,176	59
Builder line lending	511	1,411	—	1,589	—
Commercial business lending	627	631	55	638	3
Equity lines	—	—	—	—	—
Consumer	323	323	48	324	4
Total	\$ 19,880	\$ 21,501	\$ 4,010	\$ 22,164	\$ 158

The Corporation has no obligation to fund additional advances on its impaired loans.

Impaired loans, which included TDRs of \$17.09 million, and the related allowance at December 31, 2011 were as follows:

(Dollars in thousands)	Recorded Investment in Loans	Unpaid Principal Balance	Related Allowance	Average Balance Impaired Loans	Interest Income Recognized
Real estate – residential mortgage	\$ 3,482	\$3,698	\$657	\$ 3,723	\$137
Real estate – construction:					
Construction lending	—	—	—	—	—
Consumer lot lending	—	—	—	—	—
Commercial, financial and agricultural:					
Commercial real estate lending	5,861	5,957	1,464	6,195	102
Land acquisition and development lending	5,490	5,814	1,331	6,116	372
Builder line lending	2,285	2,285	318	2,397	—
Commercial business lending	652	654	161	663	6
Equity lines	—	—	—	—	—
Consumer	324	324	49	324	14
Total	\$ 18,094	\$18,732	\$3,980	\$ 19,418	\$631

Loan modifications that were classified as TDRs during the three and nine months ended September 30, 2012 and 2011 were as follows:

(Dollars in thousands)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	\$ —	\$ 86	\$ 122	\$ 629

Real estate-residential mortgage-interest reduction				
Real estate-residential mortgage-interest rate concession	—	285	—	306
Commercial, financial and agricultural:				
Commercial real estate lending – interest reduction	—	—	—	176
Commercial real estate lending – interest rate concession	3,853	3,559	4,226	3,922
Builder line lending-interest rate concession	—	—	—	2,285
Commercial business lending-interest rate concession	—	99	—	99
Consumer-interest reduction	—	—	108	—
Total	\$ 3,853	\$ 4,029	\$ 4,456	\$ 7,417

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TDR payment defaults during three and nine months ended September 30, 2012 and 2011 were as follows:

(Dollars in thousands)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Real estate-residential mortgage	\$83	\$—	\$83	\$153
Commercial, financial and agricultural:				
Commercial real estate lending	—	—	363	—
Builder line lending	—	—	88	—
Consumer	—	—	—	5
Total	\$83	\$—	\$534	\$158

For purposes of this disclosure, a TDR payment default occurs when, within 12 months of the original TDR modification, either a full or partial charge-off occurs or a TDR becomes 90 days or more past due.

## NOTE 4: Allowance for Loan Losses

The following table presents the changes in the allowance for loan losses by major classification during the nine months ended September 30, 2012.

(Dollars in thousands)	Real Estate Residential Mortgage	Real Estate Construction	Commercial, Financial and Agricultural	Equity Lines	Consumer	Consumer Finance	Total
Allowance for loan losses:							
Balance at December 31, 2011	\$2,379	\$ 480	\$ 10,040	\$ 912	\$ 319	\$19,547	\$33,677
Provision charged to operations	714	(94 )	1,219	130	116	6,465	8,550
Loans charged off	(780 )	—	(1,874 )	(120 )	(245 )	(6,731 )	(9,750 )
Recoveries of loans previously charged off	27	—	120	79	155	2,132	2,513
Balance at September 30, 2012	\$2,340	\$ 386	\$ 9,505	\$ 1,001	\$ 345	\$21,413	\$34,990

The following table presents the changes in the allowance for loan losses by major classification during the nine months ended September 30, 2011.

(Dollars in thousands)	Real Estate Residential Mortgage	Real Estate Construction	Commercial, Financial and Agricultural	Equity Lines	Consumer	Consumer Finance	Total
Allowance for loan losses:							
Balance December 31,	\$1,442	\$ 581	\$ 8,688	\$ 380	\$ 307	\$17,442	\$28,840

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2010							
Provision charged to operations	1,446	153	2,508	539	139	5,500	10,285
Loans charged off	(648 )	—	(2,541 )	(9 )	(247 )	(5,210 )	(8,655 )
Recoveries of loans previously charged off	90	—	149	—	71	1,810	2,120
Balance September 30, 2011	\$2,330	\$ 734	\$ 8,804	\$ 910	\$270	\$19,542	\$32,590

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The following table presents, as of September 30, 2012, the total allowance for loan losses, the allowance by impairment methodology (individually evaluated for impairment or collectively evaluated for impairment), total loans, and loans by impairment methodology (individually evaluated for impairment or collectively evaluated for impairment).

(Dollars in thousands)	Real Estate Residential Mortgage	Real Estate Construction	Commercial, Financial and Agricultural	Equity Lines	Consumer	Consumer Finance	Total
Allowance for loan losses:							
Balance at September 30, 2012	\$2,340	\$ 386	\$ 9,505	\$ 1,001	\$345	\$21,413	\$34,990
Ending balance: individually evaluated for impairment	\$438	\$ —	\$ 3,524	\$ —	\$48	\$—	\$4,010
Ending balance: collectively evaluated for impairment	\$1,902	\$ 386	\$ 5,981	\$ 1,001	\$297	\$21,413	\$30,980
Loans:							
Balance September 30, 2012	\$148,934	\$ 4,628	\$ 216,770	\$ 33,787	\$6,187	\$270,920	\$681,226
Ending balance: individually evaluated for impairment	\$2,249	\$ —	\$ 17,308	\$ —	\$323	\$—	\$19,880
Ending balance: collectively evaluated for impairment	\$146,685	\$ 4,628	\$ 199,462	\$ 33,787	\$5,864	\$270,920	\$661,346

The following table presents, as of December 31, 2011, the total allowance for loan losses, the allowance by impairment methodology (individually evaluated for impairment or collectively evaluated for impairment), total loans, and loans by impairment methodology (individually evaluated for impairment or collectively evaluated for impairment).

(Dollars in thousands)	Real Estate Residential Mortgage	Real Estate Construction	Commercial, Financial and Agricultural	Equity Lines	Consumer	Consumer Finance	Total
Allowance for loan losses:							
Balance at December 31, 2011	\$2,379	\$ 480	\$ 10,040	\$ 912	\$319	\$19,547	\$33,677
Ending balance: individually	\$657	\$ —	\$ 3,274	\$ —	\$49	\$—	\$3,980

evaluated for impairment							
Ending balance: collectively evaluated for impairment	\$ 1,722	\$ 480	\$ 6,766	\$ 912	\$ 270	\$ 19,547	\$ 29,697
Loans:							
Balance at December 31, 2011	\$ 147,135	\$ 5,737	\$ 212,235	\$ 33,192	\$ 6,057	\$ 246,305	\$ 650,661
Ending balance: individually evaluated for impairment	\$ 3,482	\$ —	\$ 14,288	\$ —	\$ 324	\$ —	\$ 18,094
Ending balance: collectively evaluated for impairment	\$ 143,653	\$ 5,737	\$ 197,947	\$ 33,192	\$ 5,733	\$ 246,305	\$ 632,567

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Loans by credit quality indicators as of September 30, 2012 were as follows:

(Dollars in thousands)	Pass	Special Mention	Substandard	Substandard Nonaccrual	Total1
Real estate – residential mortgage	\$ 143,871	\$ 1,131	\$ 2,831	\$ 1,101	\$ 148,934
Real estate – construction:					
Construction lending	382	—	2,867	—	3,249
Consumer lot lending	1,379	—	—	—	1,379
Commercial, financial and agricultural:					
Commercial real estate lending	105,228	2,430	10,872	4,561	123,091
Land acquisition and development lending	20,211	9,221	515	7,460	37,407
Builder line lending	12,821	1,542	1,145	527	16,035
Commercial business lending	36,875	1,816	810	736	40,237
Equity lines	31,578	1,322	839	48	33,787
Consumer	5,443	—	369	375	6,187
	\$ 357,788	\$ 17,462	\$ 20,248	\$ 14,808	\$ 410,306

(Dollars in thousands)	Performing	Non-Performing	Total
Consumer finance	\$ 270,289	\$ 631	\$ 270,920

1 At September 30, 2012, the Corporation did not have any loans classified as Doubtful or Loss.

Loans by credit quality indicators as of December 31, 2011 were as follows:

(Dollars in thousands)	Pass	Special Mention	Substandard	Substandard Nonaccrual	Total1
Real estate – residential mortgage	\$ 140,304	\$ 1,261	\$ 3,130	\$ 2,440	\$ 147,135
Real estate – construction:					
Construction lending	2,214	—	2,870	—	5,084
Consumer lot lending	653	—	—	—	653
Commercial, financial and agricultural:					
Commercial real estate lending	96,773	5,413	9,493	5,093	116,772
Land acquisition and development lending	13,605	9,939	9,101	—	32,645
Builder line lending	12,480	1,434	1,420	2,303	17,637
Commercial business lending	41,590	2,001	917	673	45,181
Equity lines	31,935	298	836	123	33,192
Consumer	5,271	10	776	—	6,057
	\$ 344,825	\$ 20,356	\$ 28,543	\$ 10,632	\$ 404,356

(Dollars in thousands)	Performing	Non-Performing	Total
Consumer finance	\$ 245,924	\$ 381	\$ 246,305

1 At December 31, 2011, the Corporation did not have any loans classified as Doubtful or Loss.





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## NOTE 5: Stockholders' Equity and Earnings Per Common Share

## Stockholders' Equity - Other Comprehensive Income

The following table presents the cumulative balances of the components of other comprehensive income, net of deferred tax assets of \$2.52 million and \$1.95 million as of September 30, 2012 and 2011, respectively.

(Dollars in thousands)	September 30,	
	2012	2011
Net unrealized gains on securities	\$ 5,960	\$ 4,341
Net unrecognized loss on cash flow hedges	(346 )	(336 )
Net unrecognized losses on defined benefit pension plan	(879 )	(328 )
Total cumulative other comprehensive income	\$ 4,735	\$ 3,677

The following tables present the changes in accumulated other comprehensive income, by category, net of tax.

(Dollars in thousands)	Unrealized Loss on Cash Flow Hedging Instruments	Unrealized Holding Gains on Securities	Defined Benefit Pension Plan Assets and Benefit Obligations	Total
Balance December 31, 2011	\$ (314 )	\$ 4,596	\$ (898 )	\$ 3,384
Net change for the nine months ended September 30, 2012	(32 )	1,364	19	1,351
Balance at September 30, 2012	\$ (346 )	\$ 5,960	\$ (879 )	\$ 4,735

(Dollars in thousands)	Unrealized Loss on Cash Flow Hedging Instruments	Unrealized Holding Gains on Securities	Defined Benefit Pension Plan Assets and Benefit Obligations	Total
Balance December 31, 2010	\$ (91 )	\$ 501	\$ (339 )	\$ 71
Net change for the nine months ended September 30, 2011	(245 )	3,840	11	3,606
Balance at September 30, 2011	\$ (336 )	\$ 4,341	\$ (328 )	\$ 3,677

The following tables present the change in each component of other comprehensive income on a pre-tax and after-tax basis for the nine months ended September 30, 2012 and 2011.

(Dollars in thousands)	Nine Months Ended September 30, 2012		
	Pre-Tax	Tax Expense (Benefit)	Net-of-Tax
Defined benefit pension plan:			
Net loss	\$ 80	\$ 28	\$ 52
Amortization of prior service costs	(51 )	(18 )	(33 )
	29	10	19

Defined benefit pension plan assets and benefit obligations, net			
Unrealized loss on cash flow hedging instruments	(51 )	(19 )	(32 )
Unrealized holding gains on securities	2,099	735	1,364
Total increase in other comprehensive income	\$ 2,077	\$ 726	\$ 1,351

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(Dollars in thousands)	Nine Months Ended September 30, 2011		
	Pre-Tax	Tax Expense (Benefit)	Net-of-Tax
Defined benefit pension plan:			
Net loss	\$ 71	\$ 25	\$ 46
Amortization of prior service costs	(51 )	(18 )	(33 )
Amortization of net obligation at transition	(3 )	(1 )	(2 )
Defined benefit pension plan assets and benefit obligations, net	17	6	11
Unrealized loss on cash flow hedging instruments	(399 )	(154 )	(245 )
Unrealized holding gains on securities	5,909	2,069	3,840
Total increase in other comprehensive income	\$ 5,527	\$ 1,921	\$ 3,606

The Corporation had \$11,000 and less than \$1,000 of net gains from securities reclassified from other comprehensive income to earnings for the nine months ended September 30, 2012 and 2011.

## Earnings Per Common Share

The components of the Corporation's earnings per common share calculations are as follows:

(Dollars in thousands)	Three Months Ended September 30,	
	2012	2011
Net income	\$ 4,533	\$ 3,513
Accumulated dividends on Series A Preferred Stock	—	(225 )
Accretion of Series A Preferred Stock discount	—	(233 )
Net income available to common shareholders	\$ 4,533	\$ 3,055
Weighted average number of common shares used in earnings per common share – basic	3,220,906	3,141,926
Effect of dilutive securities:		
Stock option awards and Warrant	112,064	32,443
Weighted average number of common shares used in earnings per common share – assuming dilution	3,332,970	3,174,369
(Dollars in thousands)	Nine Months Ended September 30,	
	2012	2011
Net income	\$ 12,494	\$ 9,565
Accumulated dividends on Series A Preferred Stock	(139 )	(725 )
Accretion of Series A Preferred Stock discount	(172 )	(312 )
Net income available to common shareholders	\$ 12,183	\$ 8,528
Weighted average number of common shares used in earnings per common share – basic	3,206,739	3,132,332
Effect of dilutive securities:		
Stock option awards and Warrant	91,291	34,598
Weighted average number of common shares used in earnings per common share – assuming dilution	3,298,030	3,166,930

Potential common shares that may be issued by the Corporation for its stock option awards and Warrant (defined below) are determined using the treasury stock method. Approximately 69,700 and 343,000 shares issuable upon

exercise of options were not included in computing diluted earnings per common share for the three months ended September 30, 2012 and 2011, respectively, and approximately 207,567 and 333,000 shares issuable upon exercise of options were not included in computing diluted earnings per common share for the nine months ended September 30, 2012 and 2011, respectively, because they were anti-dilutive.

In January 2009, the Corporation issued to the United States Department of the Treasury (Treasury) under the Capital Purchase Program (CPP) \$20.00 million of its Fixed Rate Cumulative Perpetual Preferred Stock, Series A (the Preferred Stock) and a warrant to

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purchase 167,504 shares of the Corporation's common stock (the Warrant). On July 27, 2011, the Corporation redeemed \$10.00 million of the Preferred Stock, and on April 12, 2012, the Corporation redeemed the remaining \$10.00 million of the Preferred Stock. As a result of this redemption, the Corporation will pay no future dividends on the Preferred Stock. Further, in connection with this redemption, the Corporation accelerated the accretion of the remaining preferred stock discount during April 2012, which reduced net income available to common shareholders by approximately \$151,000.

## NOTE 6: Employee Benefit Plans

The Bank has a non-contributory defined benefit plan for which the components of net periodic benefit cost are as follows:

(Dollars in thousands)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Service cost	\$ 159	\$ 153	\$ 477	\$ 459
Interest cost	99	109	296	327
Expected return on plan assets	(158 )	(145 )	(475 )	(435 )
Amortization of net obligation at transition	—	(1 )	—	(3 )
Amortization of prior service cost	(17 )	(17 )	(51 )	(51 )
Amortization of net loss	26	16	80	48
Net periodic benefit cost	\$ 109	\$ 115	\$ 327	\$ 345

The Bank made a \$500,000 contribution to this plan during the second quarter of 2012.

## NOTE 7: Fair Value of Assets and Liabilities

Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. U.S. GAAP requires that valuation techniques maximize the use of observable inputs and minimize the use of unobservable inputs. U.S. GAAP also establishes a fair value hierarchy which prioritizes the valuation inputs into three broad levels. Based on the underlying inputs, each fair value measurement in its entirety is reported in one of the three levels. These levels are:

Level 1—Valuation is based upon quoted prices for identical instruments traded in active markets. Level 1 assets and liabilities include debt and equity securities traded in an active exchange market, as well as U.S. Treasury securities.

Level 2—Valuation is based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model based valuation techniques for which all significant assumptions are observable in the market or can be corroborated by observable market data for substantially the full term of the assets or liabilities. Valuations of other real estate owned are based upon appraisals by independent, licensed appraisers, general market conditions and recent sales of like properties.

Level 3—Valuation is determined using model-based techniques with significant assumptions not observable in the market.

U.S. GAAP allows an entity the irrevocable option to elect fair value (the fair value option) for the initial and subsequent measurement for certain financial assets and liabilities on a contract-by-contract basis. The Corporation

has not made any fair value option elections as of September 30, 2012.

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## Assets and Liabilities Measured at Fair Value on a Recurring Basis

The following tables present the balances of financial assets measured at fair value on a recurring basis at September 30, 2012 and December 31, 2011.

(Dollars in thousands)	September 30, 2012			Assets at Fair Value
	Fair Value Measurements Using Level 1	Level 2	Level 3	
Assets:				
Securities available for sale				
U.S. government agencies and corporations	\$—	\$12,730	\$—	\$ 12,730
Mortgage-backed securities	—	2,464	—	2,464
Obligations of states and political subdivisions	—	125,374	—	125,374
Preferred stock	—	40	—	40
Total securities available for sale	\$—	\$140,608	\$—	\$ 140,608
Liabilities:				
Derivative payable	\$—	\$566	\$—	\$ 566

(Dollars in thousands)	December 31, 2011			Assets at Fair Value
	Fair Value Measurements Using Level 1	Level 2	Level 3	
Assets:				
Securities available for sale				
U.S. government agencies and corporations	\$—	\$15,283	\$—	\$ 15,283
Mortgage-backed securities	—	2,216	—	2,216
Obligations of states and political subdivisions	—	127,079	—	127,079
Preferred stock	—	68	—	68
Total securities available for sale	\$—	\$144,646	\$—	\$ 144,646
Liabilities:				
Derivative payable	\$—	\$515	\$—	\$ 515

## Assets and Liabilities Measured at Fair Value on a Nonrecurring Basis

The Corporation is also required to measure and recognize certain other financial assets at fair value on a nonrecurring basis in the consolidated balance sheets. For assets measured at fair value on a nonrecurring basis and still held on the consolidated balance sheets, the following table provides the fair value measures by level of valuation assumptions used. Fair value adjustments for other real estate owned (OREO) are recorded in other noninterest expense and fair value adjustments for impaired loans are recorded in the provision for loan losses, in the consolidated statements of income.

(Dollars in thousands)	September 30, 2012			Assets at Fair Value
	Fair Value Measurements Using Level 1	Level 2	Level 3	
Impaired loans, net	\$ —	\$ 15,870	\$ —	\$ 15,870
OREO, net	—	4,621	—	4,621
Total	\$ —	\$ 20,491	\$ —	\$ 20,491

December 31, 2011

(Dollars in thousands)	Fair Value Measurements Using			Assets at
	Level 1	Level 2	Level 3	Fair Value
Impaired loans, net	\$ —	\$ 14,114	\$ —	\$ 14,114
OREO, net	—	6,059	—	6,059
Total	\$ —	\$ 20,173	\$ —	\$ 20,173



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## Fair Value of Financial Instruments

The carrying values and estimated fair values of the Corporation's financial instruments, whether or not recognized on the consolidated balance sheets at fair value, as of September 30, 2012 are as follows:

(Dollars in thousands)	Carrying Value	Fair Value Measurements at September 30, 2012 Using			Balance
		Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs	
		Level 1	Level 2	Level 3	
Financial assets:					
Cash and short-term investments	\$ 13,749	\$13,749	\$—	\$ —	\$13,749
Securities	140,608	—	140,608	—	140,608
Loans, net	646,236	—	657,285	—	657,285
Loans held for sale, net	78,072	—	81,077	—	81,077
Accrued interest receivable	5,594	5,594	—	—	5,594
Financial liabilities:					
Demand deposits	\$ 371,612	\$371,612	\$—	\$ —	\$371,612
Time deposits	292,600	—	296,348	—	296,348
Borrowings	170,978	—	166,586	—	166,586
Derivative payable	566	—	566	—	566
Accrued interest payable	921	921	—	—	921

The carrying values and estimated fair values of the Corporation's financial instruments, whether or not recognized on the consolidated balance sheets at fair value, as of December 31, 2011 are as follows:

(Dollars in thousands)	December 31, 2011	
	Carrying Amount	Estimated Fair Value
Financial assets:		
Cash and short-term investments	\$ 11,507	\$ 11,507
Securities	144,646	144,646
Loans, net	616,984	624,219
Loans held for sale, net	70,062	72,859
Accrued interest receivable	5,242	5,242
Financial liabilities:		
Demand deposits	338,473	338,473
Time deposits	307,943	312,095
Borrowings	161,151	157,863
Derivative payable	515	515
Accrued interest payable	1,111	1,111

The following describes the valuation techniques used by the Corporation to measure financial assets and financial liabilities at fair value as of September 30, 2012 and December 31, 2011.

Cash and short-term investments. The nature of these instruments and their relatively short maturities provide for the reporting of fair value equal to the historical cost.

Securities available for sale. Securities available for sale are recorded at fair value on a recurring basis using a third-party model based on valuation techniques for which all significant assumptions are observable in the market or can be corroborated by observable market data.

Loans, net. The estimated fair value of the loan portfolio is based on present values using discount rates equal to the market rates currently charged on similar products.

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Certain loans are accounted for under ASC Topic 310 - Receivables, including impaired loans measured at an observable market price (if available), or at the fair value of the loan's collateral (if the loan is collateral dependent). Collateral may be in the form of real estate or business assets including equipment, inventory and accounts receivable. A significant portion of the collateral securing the Corporation's impaired loans is real estate. The fair value of real estate collateral is determined utilizing an income or market valuation approach based on an appraisal conducted by an independent, licensed appraiser outside of the Corporation using observable market data, which in some cases may be adjusted to reflect current trends, including sales prices, expenses, absorption periods and other current relevant factors (Level 2). The value of business equipment is based upon an outside appraisal if deemed significant, or the net book value on the applicable business's financial statements, if not considered significant, using observable market data (Level 2).

Loans Held for Sale. Loans held for sale are required to be measured at the lower of cost or fair value. These loans currently consist of residential loans originated for sale in the secondary market. Fair value is based on the price secondary markets are currently offering for similar loans using observable market data (Level 2). As such, the Corporation records any fair value adjustments on a nonrecurring basis. No nonrecurring fair value adjustments were recorded on loans held for sale during the nine months ended September 30, 2012.

Accrued interest receivable. The carrying amount of accrued interest receivable approximates fair value.

Deposits. The fair value of all demand deposit accounts is the amount payable at the report date. For all other deposits, the fair value is determined using the discounted cash flow method. The discount rate was equal to the rate currently offered on similar products.

Borrowings. The fair value of borrowings is determined using the discounted cash flow method. The discount rate was equal to the rate currently offered on similar products.

Derivative payable. The fair value of derivatives is determined using the discounted cash flow method.

Accrued interest payable. The carrying amount of accrued interest payable approximates fair value.

Letters of credit. The estimated fair value of letters of credit is based on estimated fees the Corporation would pay to have another entity assume its obligation under the outstanding arrangements. These fees are not considered material.

Unused portions of lines of credit. The estimated fair value of unused portions of lines of credit is based on estimated fees the Corporation would pay to have another entity assume its obligation under the outstanding arrangements. These fees are not considered material.

The Corporation assumes interest rate risk (the risk that general interest rate levels will change) as a result of its normal operations. As a result, the fair values of the Corporation's financial instruments will change when interest rate levels change and that change may be either favorable or unfavorable to the Corporation. Management attempts to match maturities of assets and liabilities to the extent believed necessary to balance minimizing interest rate risk and increasing net interest income in current market conditions. However, borrowers with fixed rate obligations are less likely to prepay in a rising rate environment and more likely to prepay in a falling rate environment. Conversely, depositors who are receiving fixed rates are more likely to withdraw funds before maturity in a rising rate environment and less likely to do so in a falling rate environment. Management monitors interest rates, maturities and repricing dates of assets and liabilities and attempts to manage interest rate risk by adjusting terms of new loans, deposits and borrowings and by investing in securities with terms that mitigate the Corporation's overall interest rate risk.



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## NOTE 8: Business Segments

The Corporation operates in a decentralized fashion in three principal business segments: Retail Banking, Mortgage Banking and Consumer Finance. Revenues from Retail Banking operations consist primarily of interest earned on loans and investment securities and service charges on deposit accounts. Mortgage Banking operating revenues consist principally of gains on sales of loans in the secondary market, loan origination fee income and interest earned on mortgage loans held for sale. Revenues from Consumer Finance consist primarily of interest earned on automobile retail installment sales contracts.

The Corporation's other segment includes an investment company that derives revenues from brokerage services, an insurance company that derives revenues from insurance services, and a title company that derives revenues from title insurance services. The results of the other segment are not significant to the Corporation as a whole and have been included in "Other." Certain expenses of the Corporation are also included in "Other," and consist primarily of interest expense associated with the Corporation's trust preferred capital notes and other general corporate expenses.

## Three Months Ended September 30, 2012

(Dollars in thousands)	Retail Banking	Mortgage Banking	Consumer Finance	Other	Eliminations	Consolidated
<b>Revenues:</b>						
Interest income	\$8,075	\$644	\$12,097	\$—	\$(1,311)	\$19,505
Gains on sales of loans	—	6,203	—	—	—	6,203
Other noninterest income	1,574	1,180	281	332	—	3,367
Total operating income	9,649	8,027	12,378	332	(1,311)	29,075
<b>Expenses:</b>						
Interest expense	1,728	135	1,608	251	(1,311)	2,411
Provision for loan losses	450	30	2,485	—	—	2,965
Salaries and employee benefits	4,006	4,887	1,926	182	—	11,001
Other noninterest expenses	3,052	1,747	1,084	103	—	5,986
Total operating expenses	9,236	6,799	7,103	536	(1,311)	22,363
Income (loss) before income taxes	413	1,228	5,275	(204)	—	6,712
Provision for (benefit from) income taxes	(292)	492	2,057	(78)	—	2,179
Net income (loss)	\$705	\$736	\$3,218	\$(126)	\$—	\$4,533
Total assets	\$792,494	\$90,164	\$272,907	\$3,062	\$(196,808)	\$961,819
Capital expenditures	\$120	\$46	\$29	\$—	\$—	\$195

## Three Months Ended September 30, 2011

(Dollars in thousands)	Retail Banking	Mortgage Banking	Consumer Finance	Other	Eliminations	Consolidated
<b>Revenues:</b>						
Interest income	\$8,270	\$398	\$11,391	\$—	\$(1,141)	\$18,918
Gains on sales of loans	—	4,282	—	—	—	4,282
Other noninterest income	1,538	748	188	384	—	2,858
Total operating income	9,808	5,428	11,579	384	(1,141)	26,058
<b>Expenses:</b>						
Interest expense	2,248	58	1,508	257	(1,140)	2,931

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Provision for loan losses	2,000	200	1,875	—	—	4,075
Salaries and employee benefits	3,486	2,595	1,657	227	—	7,965
Other noninterest expenses	3,075	1,779	1,013	91	—	5,958
Total operating expenses	10,809	4,632	6,053	575	(1,140 )	20,929
Income (loss) before income taxes	(1,001 )	796	5,526	(191 )	(1 )	5,129
Provision for (benefit from) income taxes	(784 )	319	2,155	(73 )	(1 )	1,616
Net income (loss)	\$(217 )	\$477	\$3,371	\$(118 )	\$—	\$ 3,513
Total assets	\$749,484	\$46,540	\$250,423	\$2,798	\$(140,346 )	\$ 908,899
Capital expenditures	\$288	\$12	\$101	\$—	\$—	\$ 401

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## Nine Months Ended September 30, 2012

(Dollars in thousands)	Retail Banking	Mortgage Banking	Consumer Finance	Other	Eliminations	Consolidated
Revenues:						
Interest income	\$24,238	\$1,784	\$35,131	\$—	\$(3,794)	\$57,359
Gains on sales of loans	—	15,024	—	—	—	15,024
Other noninterest income	4,604	3,275	775	1,004	—	9,658
Total operating income	28,842	20,083	35,906	1,004	(3,794)	82,041
Expenses:						
Interest expense	5,806	354	4,732	748	(3,794)	7,846
Provision for loan losses	1,950	135	6,465	—	—	8,550
Salaries and employee benefits	11,754	12,280	5,648	657	—	30,339
Other noninterest expenses	8,823	4,692	3,058	359	—	16,932
Total operating expenses	28,333	17,461	19,903	1,764	(3,794)	63,667
Income (loss) before income taxes	509	2,622	16,003	(760)	—	18,374
Provision for (benefit from) income taxes	(1,121)	1,049	6,241	(289)	—	5,880
Net income (loss)	\$1,630	\$1,573	\$9,762	\$(471)	\$—	\$12,494
Total assets	\$792,494	\$90,164	\$272,907	\$3,062	\$(196,808)	\$961,819
Capital expenditures	\$472	\$255	\$128	\$—	\$—	\$855

## Nine Months Ended September 30, 2011

(Dollars in thousands)	Retail Banking	Mortgage Banking	Consumer Finance	Other	Eliminations	Consolidated
Revenues:						
Interest income	\$24,474	\$1,185	\$32,477	\$—	\$(3,217)	\$54,919
Gains on sales of loans	—	11,778	—	—	—	11,778
Other noninterest income	4,440	2,030	519	947	—	7,936
Total operating income	28,914	14,993	32,996	947	(3,217)	74,633
Expenses:						
Interest expense	6,925	170	4,323	763	(3,218)	8,963
Provision for loan losses	4,550	235	5,500	—	—	10,285
Salaries and employee benefits	10,972	8,318	4,986	611	—	24,887
Other noninterest expenses	9,215	4,526	2,644	328	—	16,713
Total operating expenses	31,662	13,249	17,453	1,702	(3,218)	60,848
Income (loss) before income taxes	(2,748)	1,744	15,543	(755)	1	13,785
Provision for (benefit from) income taxes	(2,253)	698	6,062	(287)	—	4,220
Net income (loss)	\$(495)	\$1,046	\$9,481	\$(468)	\$1	\$9,565
Total assets	\$749,484	\$46,540	\$250,423	\$2,798	\$(140,346)	\$908,899
Capital expenditures	\$774	\$81	\$724	\$3	\$—	\$1,582

The Retail Banking segment extends a warehouse line of credit to the Mortgage Banking segment, providing a portion of the funds needed to originate mortgage loans. The Retail Banking segment charges the Mortgage Banking segment interest at the daily FHLB advance rate plus 50 basis points. The Retail Banking segment also provides the Consumer

Finance segment with a portion of the funds needed to originate loans by means of a variable rate line of credit that carries interest at one-month LIBOR plus 200 basis points and fixed rate loans that carry interest rates ranging from 3.8 percent to 8.0 percent. The Retail Banking segment acquires certain residential real estate loans from the Mortgage Banking segment at prices similar to those paid by third-party investors. These transactions are eliminated to reach consolidated totals. Certain corporate overhead costs incurred by the Retail Banking segment are not allocated to the Mortgage Banking, Consumer Finance and Other segments.



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## NOTE 9: Commitments and Financial Instruments with Off-Balance-Sheet Risk

C&F Mortgage sells substantially all of the residential mortgage loans it originates to third-party investors, some of whom may require the repurchase of loans in the event of loss due to borrower misrepresentation, fraud or early default. Mortgage loans and their related servicing rights are sold under agreements that define certain eligibility criteria for the mortgage loans. Recourse periods for early payment default vary from 90 days up to one year. Recourse periods for borrower misrepresentation or fraud, or underwriting error do not have a stated time limit. C&F Mortgage maintains an indemnification reserve for potential claims made under these recourse provisions. Risks also arise from the possible inability of counterparties to meet the terms of their contracts. C&F Mortgage has procedures in place to evaluate the credit risk of investors and does not expect any counterparty to fail to meet its obligations. The following table presents the changes in the allowance for indemnification losses for the periods presented:

(Dollars in thousands)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Allowance, beginning of period	\$ 1,657	\$ 1,536	\$ 1,702	\$ 1,291
Provision for indemnification losses	500	146	955	552
Payments	(200 )	(66 )	(700 )	(227 )
Allowance, end of period	\$ 1,957	\$ 1,616	\$ 1,957	\$ 1,616

## NOTE 10: Derivatives

The Corporation uses derivatives to manage exposure to interest rate risk through the use of interest rate swaps. Interest rate swaps involve the exchange of fixed and variable rate interest payments between two parties, based on a common notional principal amount and maturity date with no exchange of underlying principal amounts. The Corporation's interest rate swaps qualify as cash flow hedges. The Corporation's cash flow hedges effectively modify a portion of the Corporation's exposure to interest rate risk by converting variable rates of interest on \$10.00 million of the Corporation's trust preferred capital notes to fixed rates of interest until September 2015.

The cash flow hedges total notional amount is \$10.00 million. At September 30, 2012, the cash flow hedges had a fair value of (\$566,000), which is recorded in other liabilities. The cash flow hedges were fully effective at September 30, 2012 and therefore the loss on the cash flow hedges was recognized as a component of other comprehensive income (loss), net of deferred income taxes.

## NOTE 11: Other Noninterest Expenses

The following table presents the significant components in the consolidated statements of income line "Noninterest Expenses – Other Expenses."

(Dollars in thousands)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Provision for indemnification losses	\$ 500	\$ 146	\$ 955	\$ 552
Loan and OREO expenses	564	458	1,219	1,645
Data processing fees	591	533	1,650	1,664
Telecommunication expenses	292	277	879	824
FDIC expenses	150	85	477	581
Professional fees	361	451	1,215	1,479
All other noninterest expenses	1,827	2,364	5,438	5,187

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Total Other Noninterest Expenses	\$ 4,285	\$ 4,314	\$ 11,833	\$ 11,932
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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

This report contains statements concerning the Corporation's expectations, plans, objectives, future financial performance and other statements that are not historical facts. These statements may constitute "forward-looking statements" as defined by federal securities laws and may include, but are not limited to, statements regarding profitability, liquidity, the Corporation's and each business segment's loan portfolio, allowance for loan losses, trends regarding the provision for loan losses, trends regarding net loan charge-offs, trends regarding levels of nonperforming assets and troubled debt restructurings and expenses associated with nonperforming assets, provision for indemnification losses, levels of noninterest income and expense, interest rates and yields, the deposit portfolio, including trends in deposit maturities and rates, interest rate sensitivity, market risk, regulatory developments, monetary policy implemented by the Federal Reserve including quantitative easing programs, capital requirements, growth strategy and financial and other goals. These statements may address issues that involve estimates and assumptions made by management and risks and uncertainties. Actual results could differ materially from historical results or those anticipated by such statements. Factors that could have a material adverse effect on the operations and future prospects of the Corporation include, but are not limited to, changes in:

interest rates

general business conditions, as well as conditions within the financial markets

general economic conditions, including unemployment levels

the legislative/regulatory climate, including the Dodd-Frank Act and regulations promulgated thereunder and the Consumer Financial Protection Bureau (CFPB) and the regulatory and enforcement activities of the CFPB

monetary and fiscal policies of the U.S. Government, including policies of the Treasury and the Federal Reserve Board

the value of securities held in the Corporation's investment portfolios

the quality or composition of the loan portfolios and the value of the collateral securing those loans

the inventory level and pricing of used automobiles

the level of net charge-offs on loans and the adequacy of our allowance for loan losses

the level of indemnification losses related to mortgage loans sold

demand for loan products

deposit flows

the strength of the Corporation's counterparties

competition from both banks and non-banks

demand for financial services in the Corporation's market area

technology

reliance on third parties for key services

the commercial and residential real estate markets

demand in the secondary residential mortgage loan markets

the Corporation's expansion and technology initiatives

accounting principles, policies and guidelines

Any forward-looking statements should be considered in context with the various disclosures made by us about our businesses in our public filings with the Securities and Exchange Commission, including without limitation the risks identified above and those more specifically described in Item 1A. "Risk Factors" of our Annual Report on Form 10-K for the year ended December 31, 2011.

The following discussion supplements and provides information about the major components of the results of operations, financial condition, liquidity and capital resources of the Corporation. This discussion and analysis should be read in conjunction with the accompanying consolidated financial statements.

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CRITICAL ACCOUNTING POLICIES

The preparation of financial statements requires us to make estimates and assumptions. Those accounting policies with the greatest uncertainty and that require our most difficult, subjective or complex judgments affecting the application of these policies, and the likelihood that materially different amounts would be reported under different conditions, or using different assumptions, are described below.

**Allowance for Loan Losses:** We establish the allowance for loan losses through charges to earnings in the form of a provision for loan losses. Loan losses are charged against the allowance when we believe that the collection of the principal is unlikely. Subsequent recoveries of losses previously charged against the allowance are credited to the allowance. The allowance represents an amount that, in our judgment, will be adequate to absorb any losses on existing loans that may become uncollectible. Our judgment in determining the level of the allowance is based on evaluations of the collectibility of loans while taking into consideration such factors as trends in delinquencies and charge-offs, changes in the nature and volume of the loan portfolio, current economic conditions that may affect a borrower's ability to repay and the value of collateral, overall portfolio quality and review of specific potential losses. This evaluation is inherently subjective because it requires estimates that are susceptible to significant revision as more information becomes available.

**Allowance for Indemnifications:** The allowance for indemnifications is established through charges to earnings in the form of a provision for indemnifications, which is included in other noninterest expenses. A loss is charged against the allowance for indemnifications under certain conditions when a purchaser of a loan (investor) sold by C&F Mortgage incurs a loss due to borrower misrepresentation, fraud, early default, or underwriting error. The allowance represents an amount that, in management's judgment, will be adequate to absorb any losses arising from indemnification requests. Management's judgment in determining the level of the allowance is based on the volume of loans sold, historical experience, current economic conditions and information provided by investors. This evaluation is inherently subjective, as it requires estimates that are susceptible to significant revision as more information becomes available.

**Impairment of Loans:** We consider a loan impaired when it is probable that the Corporation will be unable to collect all interest and principal payments as scheduled in the loan agreement. We do not consider a loan impaired during a period of delay in payment if we expect the ultimate collection of all amounts due. We measure impairment on a loan-by-loan basis for commercial, construction and residential loans in excess of \$500,000 by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent. Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. We maintain a valuation allowance to the extent that the measure of the impaired loan is less than the recorded investment. Troubled debt restructurings (TDRs) are also considered impaired loans, even if the loan balance is less than \$500,000. A TDR occurs when we agree to significantly modify the original terms of a loan due to the deterioration in the financial condition of the borrower.

**Impairment of Securities:** Impairment of securities occurs when the fair value of a security is less than its amortized cost. For debt securities, impairment is considered other-than-temporary and recognized in its entirety in net income if either (i) we intend to sell the security or (ii) it is more-likely-than-not that we will be required to sell the security before recovery of its amortized cost basis. If, however, we do not intend to sell the security and it is not more-likely-than-not that we will be required to sell the security before recovery, we must determine what portion of the impairment is attributable to a credit loss, which occurs when the amortized cost basis of the security exceeds the present value of the cash flows expected to be collected from the security. If there is no credit loss, there is no other-than-temporary impairment. If there is a credit loss, other-than-temporary impairment exists, and the credit loss must be recognized in net income and the remaining portion of impairment must be recognized in other comprehensive income. For equity securities, impairment is considered to be other-than-temporary based on our

ability and intent to hold the investment until a recovery of fair value. Other-than-temporary impairment of an equity security results in a write-down that must be included in net income. We regularly review each investment security for other-than-temporary impairment based on criteria that includes the extent to which cost exceeds market price, the duration of that market decline, the financial health of and specific prospects for the issuer, our best estimate of the present value of cash flows expected to be collected from debt securities, our intention with regard to holding the security to maturity and the likelihood that we would be required to sell the security before recovery.

Other Real Estate Owned (OREO): Assets acquired through, or in lieu of, loan foreclosure are held for sale and are initially recorded at the lower of the loan balance or the fair value less costs to sell at the date of foreclosure. Subsequent to foreclosure, management periodically performs valuations of the foreclosed assets based on updated appraisals, general market conditions, recent sales of like properties, length of time the properties have been held, and our ability and intention with regard to continued ownership of the properties. The Corporation may incur additional write-downs of foreclosed assets to fair value less costs to sell if valuations indicate a further other-than-temporary deterioration in market conditions.

Goodwill: Goodwill is no longer subject to amortization over its estimated useful life. In assessing the recoverability of the Corporation's goodwill, all of which was recognized in connection with the Bank's acquisition of C&F Finance Company in September 2002, we must make assumptions in order to determine the fair value of the respective assets. Major assumptions used in determining if goodwill is impaired were increases in future income, sales multiples in determining terminal value and the discount rate applied to future cash flows. As part of the impairment test, we performed a sensitivity analysis by increasing the discount rate,

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lowering sales multiples and reducing increases in future income. We completed the annual test for impairment during the fourth quarter of 2011 and determined there was no impairment to be recognized in 2011. With the adoption of Accounting Standards Update 2011-08, Intangible-Goodwill and Other-Testing Goodwill for Impairment, in 2012, the Corporation will no longer be required to complete a test for impairment unless, based on an assessment of qualitative factors related to goodwill, we determine that it is more likely than not that the fair value of C&F Finance Company is less than its carrying amount. If the likelihood of impairment is more than 50 percent, the Corporation will perform a test for impairment and we may be required to record impairment charges.

**Retirement Plan:** The Bank maintains a non-contributory, defined benefit pension plan for eligible full-time employees as specified by the plan. Plan assets, which consist primarily of mutual funds invested in marketable equity securities and corporate and government fixed income securities, are valued using market quotations. The Bank's actuary determines plan obligations and annual pension expense using a number of key assumptions. Key assumptions may include the discount rate, the interest crediting rate, the estimated future return on plan assets and the anticipated rate of future salary increases. Changes in these assumptions in the future, if any, or in the method under which benefits are calculated may impact pension assets, liabilities or expense.

**Derivative Financial Instruments:** The Corporation recognizes derivative financial instruments at fair value as either an other asset or an other liability in the consolidated balance sheets. The derivative financial instruments have been designated as and qualify as cash flow hedges. The effective portion of the gain or loss on the cash flow hedges is reported as a component of other comprehensive income, net of deferred taxes, and reclassified into earnings in the same period or periods during which the hedged transaction affects earnings.

**Accounting for Income Taxes:** Determining the Corporation's effective tax rate requires judgment. In the ordinary course of business, there are transactions and calculations for which the ultimate tax outcomes are uncertain. In addition, the Corporation's tax returns are subject to audit by various tax authorities. Although we believe that the estimates are reasonable, no assurance can be given that the final tax outcome will not be materially different than that which is reflected in the income tax provision and accrual.

For further information concerning accounting policies, refer to Item 8 "Financial Statements and Supplementary Data" under the heading "Note 1: Summary of Significant Accounting Policies" in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2011.

## OVERVIEW

Our primary financial goals are to maximize the Corporation's earnings and to deploy capital in profitable growth initiatives that will enhance long-term shareholder value. We track three primary financial performance measures in order to assess the level of success in achieving these goals: (i) return on average assets (ROA), (ii) return on average common equity (ROE), and (iii) growth in earnings. In addition to these financial performance measures, we track the performance of the Corporation's three principal business activities: retail banking, mortgage banking, and consumer finance. We also actively manage our capital through growth and dividends, while considering the need to maintain a strong regulatory capital position.

### Financial Performance Measures

Net income for the Corporation was \$4.5 million for the three months ended September 30, 2012, compared with \$3.5 million for the three months ended September 30, 2011. Net income for the Corporation was \$12.5 million for the first nine months of 2012, compared with \$9.6 million for the first nine months of 2011. Net income available to common shareholders was \$4.5 million, or \$1.36 per common share assuming dilution, for the three months ended September 30, 2012, compared with \$3.1 million, or \$0.96 per common share assuming dilution, for the three months ended

September 30, 2011. Net income available to common shareholders was \$12.2 million, or \$3.69 per common share assuming dilution for the first nine months of 2012, compared with \$8.5 million, or \$2.69 per common share assuming dilution for the first nine months of 2011. The difference between reported net income and net income available to common shareholders is a result of the Preferred Stock dividends and amortization of the Warrant related to the Corporation's participation in the CPP. The Corporation's earnings for the third quarter and first nine months of 2012 were primarily a result of the strong earnings in the Consumer Finance segment, which continues to benefit from (1) sustained loan growth and (2) the low funding costs on its variable-rate borrowings. The Mortgage Banking segment benefited from higher gains on loans sold and ancillary loan production fees as a result of higher loan production and correspondingly higher sales volume during 2012, as well as lower professional fees. The Retail Banking segment benefited from the effects of (1) the continued low interest rate environment on the cost of deposits, (2) lower provisions for loan losses and (3) higher interchange activity fee.



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The Corporation's ROE and ROA were 18.48 percent and 1.88 percent, respectively, on an annualized basis for the third quarter of 2012, compared with 15.86 percent and 1.42 percent, respectively, for the third quarter of 2011. For the first nine months of 2012, on an annualized basis, the Corporation's ROE and ROA were 17.74 percent and 1.75 percent, respectively, compared with 14.92 percent and 1.28 percent, respectively, for the first nine months of 2011. The increase in these ratios during 2012 was primarily due to the earnings improvement of the Retail Banking and Mortgage Banking segments and the sustained earnings strength of the Consumer Finance segment. In addition, the effect of dividends on the Corporation's Preferred Stock on net income available to common shareholders was lessened for the third quarter and first nine months of 2012 by the redemptions of Preferred Stock in July 2011 and in April 2012.

**Principal Business Activities.** An overview of the financial results for each of the Corporation's principal business segments is presented below. A more detailed discussion is included in "Results of Operations."

**Retail Banking:** C&F Bank reported net income of \$705,000 for the third quarter of 2012, compared to a net loss of \$217,000 for the third quarter of 2011. For the first nine months of 2012, C&F Bank reported net income of \$1.6 million, compared to a net loss of \$495,000 for the first nine months of 2011. The more significant factors contributing to the improvement in financial results for the three and nine months ended September 30, 2012, relative to the same periods of 2011, were the effects of the continued low interest rate environment on the cost of deposits, lower provisions for loan losses and higher activity-based interchange income. Partially offsetting these positive factors were the negative effects of the following: (1) a decrease in average loans to nonaffiliates resulting from weak demand in the current economic environment and intensified competition for loans in our markets, (2) a decline in overdraft fee income and (3) slightly higher occupancy expenses associated with depreciation and maintenance of technology related to expanding the banking services we offer to customers and improving operational efficiency and security.

The Bank's nonperforming assets were \$19.4 million at September 30, 2012, compared to \$16.1 million at December 31, 2011. Nonperforming assets at September 30, 2012 included \$14.8 million in nonaccrual loans, compared to \$10.0 million at December 31, 2011, and \$4.6 million in foreclosed properties, compared to \$6.1 million at December 31, 2011. Troubled debt restructurings were \$17.9 million at September 30, 2012, of which \$11.4 million were included in nonaccrual loans, as compared to \$17.1 million of troubled debt restructurings at December 31, 2011, of which \$8.4 million were included in nonaccrual loans. The increase in nonaccrual loans primarily resulted from two commercial relationships secured by undeveloped residential property totaling \$7.5 million as of September 30, 2012, of which \$5.4 million was included in troubled debt restructurings at September 30, 2012. Management believes it has provided adequate loan loss reserves for the retail banking segment's loans. Foreclosed properties at September 30, 2012 consist of both residential and non-residential properties. These properties are evaluated regularly and have been written down to their estimated fair values less selling costs.

**Mortgage Banking:** C&F Mortgage Corporation reported net income of \$736,000 for the third quarter of 2012, compared to \$477,000 for the third quarter of 2011. For the first nine months of 2012, C&F Mortgage Corporation reported net income of \$1.6 million, compared to \$1.0 million for the first nine months of 2011. The more significant factors contributing to the improvements in financial results for the three months and nine months ended September 30, 2012, relative to the same periods of 2011, were (1) higher gains on sales of loans and ancillary loan production fees, (2) higher net interest income on loans held for sale and (3) lower legal and consulting expenses. Loan origination volume increased to \$239.5 million in the third quarter of 2012, a 54.9 percent increase as compared to \$154.6 million in the third quarter of 2011, and to \$619.5 million in the first nine months of 2012, a 44.8 percent increase as compared to \$427.7 million in the first nine months of 2011. For the third quarter of 2012, the amount of loan originations for refinancings and home purchases were \$105.4 million and \$134.1 million, respectively, compared to \$37.1 million and \$117.5 million, respectively, for the third quarter of 2011. For the first nine months of 2012, the amount of loan originations for refinancings and home purchases were \$240.9 million and \$378.6 million,

respectively, compared to \$97.2 million and \$330.5 million, respectively, for the first nine months of 2011. The increases in loan originations are a result of the continued low interest rate environment that has led to increased mortgage borrowing and refinancing activity. These increases have led to correspondingly higher sales volume, which increased to \$240.6 million for the third quarter of 2012, compared to \$154.6 million during the third quarter of 2011, and which increased to \$611.4 million for the first nine months of 2012, compared to \$458.5 million during the first nine months of 2011. In connection with the higher sales volumes in 2012, the mortgage banking segment incurred higher production and income-based compensation expense. Higher personnel costs have also been incurred in non-production salaries in order to manage the increasingly complex regulatory environment in which the mortgage banking segment operates and higher provisions for indemnifications have been recognized in connection with loans sold to investors.

Consumer Finance: C&F Finance Company reported net income of \$3.2 million for the third quarter of 2012, compared to net income of \$3.4 million for the third quarter of 2011. For the first nine months of 2012, C&F Finance reported net income of \$9.8 million, compared to net income of \$9.5 million for the first nine months of 2011. The more significant factors contributing to the consumer finance segment's financial results for the three and nine months ended September 30, 2012 compared to the same periods in 2011 were (1) an 8.9 percent and a 9.7 percent increase in average loans outstanding for the three and nine months ended September 30, 2012, respectively, and (2) the sustained low cost of the consumer finance segment's variable-rate borrowings. Factors negatively affecting the financial results for the three and nine months ended September 30, 2012, relative to the same periods of 2011, were (1) increases of \$610,000 and \$965,000 in the provision for loan losses for the three and nine months ended September 30, 2012, respectively, resulting from higher net charge-offs attributable to a decline in the resale value of repossessed vehicles and the effects of the current economic environment, (2) increases of \$269,000 and \$662,000 in personnel costs for the three and nine months ended September 30, 2012, respectively, resulting from an increase in the number of personnel to support expansion into new markets and loan growth and (3) increases of \$13,000 and \$162,000 in occupancy expenses for the three and nine months ended September 30, 2012, respectively, resulting from C&F Finance Company's relocation in April 2011 to a larger leased headquarters building and depreciation and maintenance of technology to support growth.

Despite the increase in the dollar amount of charge-offs, as mentioned above, the 2.37 percent annualized charge-off rate for the first nine months of 2012 was slightly lower than the 2.39 percent charge-off rate for the year ended December 31, 2011. The allowance

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for loan losses as a percentage of consumer finance loans was relatively stable at 7.90 percent as of September 30, 2012, compared with 7.94 percent at December 31, 2011. Management believes that the current allowance for loan losses is adequate to absorb probable losses in the Consumer Finance segment's loan portfolio.

Other and Eliminations: The net loss for the three months ended September 30, 2012 for this combined segment was \$126,000, compared to a net loss of \$118,000 for the three months ended September 30, 2011. The net loss for the first nine months of 2012 for this combined segment was \$471,000, compared to a net loss of \$467,000 for the first nine months of 2011. Revenue and expense of this combined segment include the results of operations of our investment, insurance and title subsidiaries, interest expense associated with the Corporation's trust preferred capital notes, other general corporate expenses and the effects of intercompany eliminations.

Capital Management. Total shareholders' equity was \$98.5 million at September 30, 2012, compared to \$96.1 million at December 31, 2011, which was an increase of \$2.4 million. The increase in shareholders' equity resulting from net income for the first nine months of 2012 was offset in part by dividends declared and the redemption of the Corporation's Preferred Stock, as described below. The Corporation declared cash dividends of 27 cents and 79 cents per common share during the third quarter and first nine months of 2012, respectively, which was a 19.2 percent and a 20.8 percent payout ratio of net income available to common shareholders for the third quarter and first nine months of 2012, respectively.

On April 11, 2012, the Corporation redeemed the remaining 10,000 shares of its Preferred Stock issued to Treasury in January 2009 under the CPP. The redemption consisted of \$10.0 million in liquidation value and \$78,000 of accrued and unpaid dividends associated with the Preferred Stock. As a result of this redemption, the Corporation will pay no future dividends on the Preferred Stock. The Corporation funded this redemption without raising additional capital because of its strong capital position and financial performance. The redemption results in no dilution to common shareholders because no new capital was issued. In connection with this redemption, the Corporation accelerated the accretion of the remaining Preferred Stock discount, which reduced net income available to common shareholders by approximately \$151,000 in the second quarter of 2012, but eliminated any future accretion.

RESULTS OF OPERATIONS

The following table presents the average balance sheets, the amounts of interest earned on earning assets, with related yields, and interest expense on interest-bearing liabilities, with related rates, for the three and nine months ended September 30, 2012 and 2011. Loans include loans held for sale. Loans placed on nonaccrual status are included in the balances and are included in the computation of yields, but had no material effect. Interest on tax-exempt loans and securities is presented on a taxable-equivalent basis (which converts the income on loans and investments for which no income taxes are paid to the equivalent yield as if income taxes were paid using the federal corporate income tax rate of 34 percent).

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TABLE 1: Average Balances, Income and Expense, Yields and Rates

(Dollars in thousands)	Three Months Ended September 30,					
	Average Balance	2012 Income/ Expense	Yield/ Rate	Average Balance	2011 Income/ Expense	Yield/ Rate
<b>Assets</b>						
<b>Securities:</b>						
Taxable	\$19,327	\$78	1.61 %	\$18,842	\$78	1.63 %
Tax-exempt	116,333	1,729	5.95	120,482	1,852	6.26
Total securities	135,660	1,807	5.33	139,324	1,930	5.54
Loans, net	747,239	18,297	9.74	689,193	17,611	10.14
<b>Interest-bearing deposits in other banks and Federal funds sold</b>						
	5,351	2	0.15	12,486	7	0.20
Total earning assets	888,250	20,106	9.01	841,003	19,548	9.23
Allowance for loan losses	(35,829 )			(31,012 )		
Total non-earning assets	93,482			94,830		
Total assets	\$945,903			\$904,821		
<b>Liabilities and Shareholders' Equity</b>						
<b>Time and savings deposits:</b>						
Interest-bearing deposits	\$102,985	\$78	0.30 %	\$105,518	\$109	0.41 %
Money market deposit accounts	104,098	94	0.36	81,556	126	0.62
Savings accounts	45,921	12	0.10	41,986	12	0.11
Certificates of deposit, \$100 or more	130,884	452	1.37	137,695	677	1.95
Other certificates of deposit	162,018	565	1.39	169,057	785	1.84
Total time and savings deposits	545,906	1,201	0.87	535,812	1,709	1.27
Borrowings	168,287	1,210	2.82	159,743	1,222	3.06
Total interest-bearing liabilities	714,193	2,411	1.33	695,555	2,931	1.68
Demand deposits	109,459			95,691		
Other liabilities	25,808			19,580		
Total liabilities	849,460			810,826		
Shareholders' equity	96,443			93,995		
Total liabilities and shareholders' equity	\$945,903			\$904,821		
Net interest income		\$17,695			\$16,617	
Interest rate spread			7.68 %			7.55 %
Interest expense to average earning assets (annualized)			1.07 %			1.39 %
Net interest margin (annualized)			7.94 %			7.84 %

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(Dollars in thousands)	Nine Months Ended September 30,							
	Average Balance	2012 Income/ Expense	Yield/ Rate		Average Balance	2011 Income/ Expense	Yield/ Rate	
Assets								
Securities:								
Taxable	\$20,197	\$246	1.62	%	\$19,819	\$240	1.61	%
Tax-exempt	117,856	5,324	6.02		118,262	5,517	6.26	
Total securities	138,053	5,570	5.38		138,081	5,757	5.56	
Loans, net	726,599	53,624	9.86		677,154	51,029	10.07	
Interest-bearing deposits in other banks and Federal funds sold	10,413	15	0.19		21,295	38	0.23	
Total earning assets	875,065	59,209	9.04		836,530	56,824	9.07	
Allowance for loan losses	(35,045 )				(29,815 )			
Total non-earning assets	92,709				95,832			
Total assets	\$932,729				\$902,547			
Liabilities and Shareholders' Equity								
Time and savings deposits:								
Interest-bearing deposits	\$108,278	\$317	0.39	%	\$110,118	\$430	0.52	%
Money market deposit accounts	94,564	284	0.40		76,159	391	0.69	
Savings accounts	45,101	33	0.10		42,070	32	0.10	
Certificates of deposit, \$100 or more	136,291	1,639	1.61		134,290	2,013	2.01	
Other certificates of deposit	164,858	1,926	1.56		172,868	2,454	1.90	
Total time and savings deposits	549,092	4,199	1.02		535,505	5,320	1.33	
Borrowings	162,443	3,647	2.99		159,720	3,643	3.04	
Total interest-bearing liabilities	711,535	7,846	1.47		695,225	8,963	1.72	
Demand deposits	102,460				92,409			
Other liabilities	22,914				19,778			
Total liabilities	836,909				807,412			
Shareholders' equity	95,820				95,135			
Total liabilities and shareholders' equity	\$932,729				\$902,547			
Net interest income		\$51,363				\$47,861		
Interest rate spread			7.56	%			7.35	%
Interest expense to average earning assets (annualized)			1.20	%			1.43	%
Net interest margin (annualized)			7.84	%			7.64	%

Interest income and expense are affected by fluctuations in interest rates, by changes in the volume of earning assets and interest-bearing liabilities, and by the interaction of rate and volume factors. The following table presents the direct causes of the period-to-period changes in the components of net interest income on a taxable-equivalent basis. We calculated the rate and volume variances using a formula prescribed by the Securities and Exchange Commission (SEC). Rate/volume variances, the third element in the calculation, are not shown separately in the table, but are

allocated to the rate and volume variances in proportion to the relationship of the absolute dollar amounts of the change in each. Loans include both nonaccrual loans and loans held for sale.

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TABLE 2: Rate-Volume Recap

(Dollars in thousands)	Three Months Ended September 30, 2012 from 2011		
	Increase (Decrease)		Total Increase (Decrease)
	Rate	Due to Volume	
Interest income:			
Loans	\$(722 )	\$1,408	\$686
Securities:			
Taxable	(2 )	2	—
Tax-exempt	(60 )	(63 )	(123 )
Interest-bearing deposits in other banks and Federal funds sold	(1 )	(4 )	(5 )
Total interest income	(785 )	1,343	558
Interest expense:			
Time and savings deposits:			
Interest-bearing deposits	(28 )	(3 )	(31 )
Money market deposit accounts	(61 )	29	(32 )
Savings accounts	(1 )	1	—
Certificates of deposit, \$100 or more	(193 )	(32 )	(225 )
Other certificates of deposit	(189 )	(31 )	(220 )
Total time and savings deposits	(472 )	(36 )	(508 )
Borrowings (including Trust preferred capital notes)	(88 )	76	(12 )
Total interest expense	(560 )	40	(520 )
Change in net interest income	\$(225 )	\$1,303	\$1,078

(Dollars in thousands)	Nine Months Ended September 30, 2012 from 2011		
	Increase (Decrease)		Total Increase (Decrease)
	Rate	Due to Volume	
Interest income:			
Loans	\$(1,114 )	\$3,709	\$2,595
Securities:			
Taxable	1	5	6
Tax-exempt	(174 )	(19 )	(193 )
Interest-bearing deposits in other banks and Federal funds sold	(1 )	(22 )	(23 )
Total interest income	(1,287 )	3,672	\$2,385
Interest expense:			
Time and savings deposits:			
Interest-bearing deposits	(105 )	(8 )	(113 )
Money market deposit accounts	(187 )	80	(107 )
Savings accounts	(1 )	2	1
Certificates of deposit, \$100 or more	(404 )	30	(374 )
Other certificates of deposit	(419 )	(110 )	(528 )
Total time and savings deposits	(1,116 )	(6 )	(1,121 )
Borrowings (including Trust preferred capital notes)	(58 )	63	4

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Total interest expense	(1,174	)	57	(1,117	)
Change in net interest income	\$(113	)	\$3,615	\$3,502	

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Net interest income, on a taxable-equivalent basis, for the three months ended September 30, 2012 was \$17.7 million, compared to \$16.6 million for the three months ended September 30, 2011. Net interest income, on a taxable-equivalent basis, for the first nine months of 2012 was \$51.4 million, compared to \$47.9 million for the first nine months of 2011. The higher net interest income during the third quarter of 2012, as compared to the same period of 2011, resulted from a 10 basis point increase in net interest margin to 7.94 percent, coupled with a 5.6 percent increase in average earning assets. The higher net interest income during the first nine months of 2012, as compared to the same period of 2011, resulted from a 20 basis point increase in net interest margin to 7.84 percent, coupled with a 4.6 percent increase in average earning assets. The increases in net interest margin for the three and nine months ended September 30, 2012, compared to the same periods in 2011, were principally a result of growth in the Consumer Finance segment's loan portfolio (which generates higher yields than the Retail Banking segment's loan portfolio) and decreases in the rates paid by the Retail Banking segment on savings and time deposits, partially offset by lower yields on the aggregate loan portfolio and municipal securities. The decreases in rates paid on time and savings deposits were primarily a result of the sustained low interest rate environment and the repricing of higher rate certificates of deposit as they matured to lower rates. In addition, the mix in interest-bearing deposits has shifted to shorter-term deposit accounts. The decreases in the yields on loans resulted primarily from higher average loans held for sale at the Mortgage Banking segment, which typically are lower yielding than loans held for investment. The increases in average loans held for sale offset the favorable effects of a change in the mix of loans held for investment, namely slight increases in higher yielding average loans at the Consumer Finance segment and declines in lower yielding average loans at the Retail Banking segment, which resulted in higher yields on loans held for investment. The decline in the yields on securities resulted from calls and maturities of higher-yielding securities and purchases of municipal securities with lower yields in the current low interest rate environment.

Average loans, which includes both loans held for investment and loans held for sale, increased \$58.0 million to \$747.2 million for the quarter ended September 30, 2012 from \$689.2 million for the third quarter of 2011. Similarly, average loans increased \$49.4 million to \$726.6 million for the first nine months of 2012 from \$677.2 million for the first nine months of 2011. A portion of the increase occurred in the Mortgage Banking segment's portfolio of loans held for sale, the average balance of which increased \$37.8 million during the third quarter of 2012 and \$30.8 million during the first nine months of 2012. This increase is indicative of the higher loan production due to the continued low interest rate environment that has led to increased mortgage borrowing and refinancing activity. In total, average loans to non-affiliates held for investment increased \$20.3 million during the third quarter of 2012 and \$18.7 million during the first nine months of 2012, compared to the same respective periods of 2011. The Consumer Finance segment's average loan portfolio, which increased \$21.9 million during the third quarter of 2012 and \$22.7 million during the first nine months of 2012 increased as a result of demand in existing and new markets. The increases in average loans at the Consumer Finance segment were offset in part by decreases of \$1.6 million during the third quarter of 2012 and \$4.1 million during the first nine months of 2012 in the Retail Banking and Mortgage Banking segments' portfolios of average loans held for investment. Loan production at the Retail Banking segment has been negatively affected by weak demand for new loans in the current economic environment and intensified competition for loans in our markets.

The overall yields on average loans decreased 40 basis points to 9.74 percent for the third quarter of 2012 and 21 basis points to 9.86 percent for the first nine months of 2012, when compared to the same periods in 2011, principally as a result of higher levels of lower-yielding Mortgage Banking segment loans held for sale as a percentage of total loans, as well as a slight decrease in the yield for the three and nine months ended September 30, 2012 on the Consumer Finance segment loans as a result of increased competition for automobile financing loans in the segment's markets.

Average securities available for sale decreased \$3.7 million in the third quarter of 2012 and \$28,000 in the first nine months of 2012 when compared to the same periods in 2011. These decreases reflect the effect of the lower interest rate environment on call activity, as well as on the availability of reinvestment opportunities that satisfy the investment portfolio's role in managing interest rate sensitivity, providing liquidity and serving as an additional source

of interest income. The lower yields on the available-for-sale securities portfolio during the third quarter and first nine months of 2012, compared to the same periods in 2011, resulted from the calls and maturities of higher-yielding securities and purchases of lower-yielding securities in the current low interest rate environment, as well as purchases of shorter-term securities with lower yields throughout 2011 and continuing into 2012.

Average interest-bearing deposits in other banks and Federal funds sold decreased \$7.1 million and \$10.9 million during the third quarter and first nine months of 2012, respectively, compared to the same periods in 2011, as a result of deploying excess liquidity to partially fund loan demand at the Mortgage Banking and Consumer Finance segments. The average yield on these overnight funds declined 5 basis points and 4 basis points during the third quarter and first nine months of 2012, respectively, compared to the same periods in 2011, as a result of the continuing low interest rate environment.

Average interest-bearing time and savings deposits increased \$10.1 million in the third quarter of 2012 and \$13.6 million in the first nine months of 2012, compared to the same periods in 2011, mainly due to a shift to shorter-term money market deposit accounts, which allows depositors greater flexibility for funds management and investing decisions in this low interest rate environment. The average cost of deposits declined 40 basis points for the third quarter of 2012 and 31 basis points for the first nine months of 2012, compared to the same periods in 2011, because time deposits that matured throughout 2011 and into 2012 repriced at lower interest rates or were not renewed, interest rates paid on interest-bearing demand and money market deposit accounts decreased as a result of

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the sustained low interest rate environment, and the balances of shorter-term savings and money market deposits, which pay a lower interest rate, increased.

Average borrowings increased \$8.5 million and \$2.7 million in the third quarter and first nine months of 2012, respectively, when compared to the same periods in 2011. These increases occurred in short-term fed funds purchased in order to fund the Mortgage Banking segment's portfolio of loans held for sale. The average cost of borrowings declined 24 basis points for the third quarter of 2012 and 5 basis points for the first nine months of 2012, compared to the same periods in 2011, because of the higher average balance of fed funds purchased in relation to total borrowings, as well as the maturity of \$10.0 million of FHLB advances during the third quarter of 2012, which were replaced by advances carrying lower interest rates.

In September 2012, the Federal Reserve announced a third round of quantitative easing that is expected by many market observers to last at least until early 2014. The Corporation anticipates this round of quantitative easing will keep interest rates low, which will most likely preserve the low rate environment that has been favorable to the Mortgage Banking segment's operations during the first nine months of 2012. It will be challenging to maintain the Retail Banking segment's net interest margin at its current level if funds obtained from loan repayments and from deposit growth cannot be fully used to originate new loans and instead are reinvested in lower-yielding earning assets, and if the reduction in earning asset yields exceeds interest rate declines in interest-bearing liabilities. With the expectation that short-term interest rates will not change significantly and the current low rate environment will continue, the net interest margin at the Consumer Finance segment will be most affected by increasing competition and loan pricing strategies that these competitors may use to grow market share in automobile financing.

## Noninterest Income

TABLE 3: Noninterest Income

(Dollars in thousands)	Three Months Ended September 30, 2012				
	Retail Banking	Mortgage Banking	Consumer Finance	Other and Eliminations	Total
Gains on sales of loans	\$—	\$6,203	\$—	\$—	\$6,203
Service charges on deposit accounts	823	—	—	—	823
Other service charges and fees	623	1,006	3	53	1,685
Gains on calls of available for sale securities	3	—	—	—	3
Other income	125	174	278	279	856
Total noninterest income	\$1,574	\$7,383	\$281	\$332	\$9,570

(Dollars in thousands)	Three Months Ended September 30, 2011				
	Retail Banking	Mortgage Banking	Consumer Finance	Other and Eliminations	Total
Gains on sales of loans	\$—	\$4,282	\$—	\$—	\$4,282
Service charges on deposit accounts	915	—	—	—	915
Other service charges and fees	582	747	3	38	1,370
Gains on calls of available for sale securities	1	—	—	—	1
Other income	40	1	185	346	572
Total noninterest income	\$1,538	\$5,030	\$188	\$384	\$7,140

(Dollars in thousands)	Nine Months Ended September 30, 2012				
	Retail Banking	Mortgage Banking	Consumer Finance	Other and Eliminations	Total

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Gains on sales of loans	\$ —	\$ 15,024	\$ —	\$ —	\$ 15,024
Service charges on deposit accounts	2,449	—	—	—	2,449
Other service charges and fees	1,801	2,707	9	144	4,661
Gains on calls of available for sale securities	11	—	—	—	11
Other income	343	568	766	860	2,537
Total noninterest income	\$ 4,604	\$ 18,299	\$ 775	\$ 1,004	\$ 24,682

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(Dollars in thousands)

	Nine Months Ended September 30, 2011				
	Retail Banking	Mortgage Banking	Consumer Finance	Other and Eliminations	Total
Gains on sales of loans	\$—	\$11,778	\$—	\$—	\$11,778
Service charges on deposit accounts	2,609	—	—	—	2,609
Other service charges and fees	1,677	1,975	7	117	3,776
Gains on calls of available for sale securities	1	—	—	—	1
Other income	153	55	512	830	1,550
Total noninterest income	\$4,440	\$13,808	\$519	\$ 947	\$19,714

Total noninterest income increased \$2.4 million, or 34.0 percent, in the third quarter of 2012 and \$5.0 million, or 25.2 percent, in the first nine months of 2012, compared to the same periods in 2011. These increases resulted from higher gains on sales of loans and ancillary loan production fees at the Mortgage Banking segment due to the increase in loan originations and sales, coupled with increases in other income from higher activity-based debit card interchange fees at the Retail Banking segment. Partially offsetting these increases was a decline in the Retail Banking segment's service charges on deposit accounts, which resulted from lower overdraft fees during the third quarter and first nine months of 2012.

## Noninterest Expense

TABLE 4: Noninterest Expenses

(Dollars in thousands)

	Three Months Ended September 30, 2012				
	Retail Banking	Mortgage Banking	Consumer Finance	Other and Eliminations	Total
Salaries and employee benefits	\$4,006	\$4,887	\$1,926	\$ 182	\$11,001
Occupancy expenses	1,018	468	211	4	1,701
Other expenses:					
OREO expenses	485	—	—	—	485
Provision for indemnification losses	—	500	—	—	500
Other expenses	1,549	779	873	99	3,300
Total other expenses	2,034	1,279	873	99	4,285
Total noninterest expenses	\$7,058	\$6,634	\$3,010	\$ 285	\$16,987

(Dollars in thousands)

	Three Months Ended September 30, 2011				
	Retail Banking	Mortgage Banking	Consumer Finance	Other and Eliminations	Total
Salaries and employee benefits	\$3,486	\$2,595	\$1,657	\$ 227	\$7,965
Occupancy expenses	966	474	198	6	1,644
Other expenses:					
OREO expenses	335	—	—	—	335
Provision for indemnification losses	—	146	—	—	146
Other expenses	1,774	1,159	815	85	3,833
Total other expenses	2,109	1,305	815	85	4,314
Total noninterest expenses	\$6,561	\$4,374	\$2,670	\$ 318	\$13,923

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(Dollars in thousands)	Nine Months Ended September 30, 2012				
	Retail Banking	Mortgage Banking	Consumer Finance	Other and Eliminations	Total
Salaries and employee benefits	\$11,754	\$12,280	\$5,648	\$ 657	\$30,339
Occupancy expenses	3,024	1,429	629	17	5,099
Other expenses:					
OREO expenses	927	—	—	—	927
Provision for indemnification losses	—	955	—	—	955
Other expenses	4,872	2,308	2,429	342	9,951
Total other expenses	5,799	3,263	2,429	342	11,833
Total noninterest expenses	\$20,577	\$16,972	\$8,706	\$ 1,016	\$47,271

(Dollars in thousands)	Nine Months Ended September 30, 2011				
	Retail Banking	Mortgage Banking	Consumer Finance	Other and Eliminations	Total
Salaries and employee benefits	\$10,972	\$8,318	\$4,986	\$ 611	\$24,887
Occupancy expenses	2,874	1,421	467	19	4,781
Other expenses:					
OREO expenses	1,111	11	—	—	1,122
Provision for indemnification losses	—	552	—	—	552
Other expenses	5,230	2,542	2,177	309	10,258
Total other expenses	6,341	3,105	2,177	309	11,932
Total noninterest expenses	\$20,187	\$12,844	\$7,630	\$ 939	\$41,600

Total noninterest expenses increased \$3.1 million, or 22.0 percent, in the third quarter of 2012 and \$5.7 million, or 13.6 percent, in the first nine months of 2012, compared to the same periods in 2011. These increases resulted primarily from higher personnel costs at (1) the Retail Banking segment due to increased staffing in the branch network to support customer service initiatives, (2) the Mortgage Banking segment due to higher production and income-based compensation, which resulted from the increase in loan production and sales during the third quarter and first nine months of 2012, as well as higher non-production compensation in order to manage the increasingly complex regulatory environment in which the Mortgage Banking segment operates and (3) the Consumer Finance segment due to an increase in the number of personnel to support expansion into new markets and loan growth. In addition, there were increases in occupancy expense during the third quarter and first nine months of 2012 as compared to the same periods of 2011 at the Consumer Finance segment due to the relocation in April 2011 to a larger leased headquarters building and depreciation and maintenance of technology to support growth. The Mortgage Banking segment recognized higher provisions for indemnification losses during the third quarter and first nine months of 2012 as compared to the same periods of 2011 in connection with loans sold to investors. These increases were partially offset by lower loan and OREO expenses at the Retail Banking segment for the three and nine months ended September 30, 2012, as well as lower FDIC insurance premiums during the first nine months of 2012 as compared to the same periods of 2011.

## Income Taxes

Income tax expense for the third quarter of 2012 totaled \$2.2 million, resulting in an effective tax rate of 32.5 percent, compared to \$1.6 million and 31.5 percent for the third quarter of 2011. Income tax expense for the first nine months of 2012 totaled \$5.9 million, resulting in an effective tax rate of 32.0 percent, compared to \$4.2 million and 30.6 percent for the first nine months of 2011. Generally, the increases in the effective tax rates during the third quarter and first nine months of 2012 were a result of higher pre-tax earnings at the non-bank business segments, which are not exempt from state income taxes and do not generate tax-exempt income, coupled with lower tax-exempt income at the

Retail Banking segment generated by tax-exempt securities issued by states and political subdivisions.

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## ASSET QUALITY

## Allowance for Loan Losses

The allowance for loan losses represents an amount that, in our judgment, will be adequate to absorb any losses on existing loans that may become uncollectible. The provision for loan losses increases the allowance, and loans charged off, net of recoveries, reduce the allowance. The following tables summarize the allowance activity for the periods indicated:

TABLE 5: Allowance for Loan Losses

(Dollars in thousands)	Three Months Ended September				
	2012		2011		
Allowance, beginning of period	\$	35,457	\$	30,211	
Provision for loan losses:					
Retail Banking segment		450		2,000	
Mortgage Banking segment		30		200	
Consumer Finance segment		2,485		1,875	
Total provision for loan losses		2,965		4,075	
Loans charged off:					
Real estate—residential mortgage		142		365	
Real estate—construction 1		—		—	
Commercial, financial and agricultural 2		1,472		11	
Equity lines		—		—	
Consumer		73		80	
Consumer finance		2,629		2,095	
Total loans charged off		4,316		2,551	
Recoveries of loans previously charged off:					
Real estate—residential mortgage		4		76	
Real estate—construction 1		—		—	
Commercial, financial and agricultural 2		84		128	
Equity lines		79		—	
Consumer		56		30	
Consumer finance		661		621	
Total recoveries		884		855	
Net loans charged off		3,432		1,696	
Allowance, end of period	\$	34,990	\$	32,590	
Ratio of annualized net charge-offs to average total loans outstanding during period for Retail Banking and Mortgage Banking		1.44	%	0.45	%
Ratio of annualized net charge-offs to average total loans outstanding during period for Consumer Finance		2.93	%	2.01	%



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(Dollars in thousands)	Nine Months Ended September 30,				
	2012		2011		
Allowance, beginning of period	\$	33,677	\$	28,840	
Provision for loan losses:					
Retail Banking segment		1,950		4,550	
Mortgage Banking segment		135		235	
Consumer Finance segment		6,465		5,500	
Total provision for loan losses		8,550		10,285	
Loans charged off:					
Real estate—residential mortgage		780		648	
Real estate—construction 1		—		—	
Commercial, financial and agricultural 2		1,874		2,541	
Equity lines		120		9	
Consumer		245		247	
Consumer finance		6,731		5,210	
Total loans charged off		9,750		8,655	
Recoveries of loans previously charged off:					
Real estate—residential mortgage		27		90	
Real estate—construction 1		—		—	
Commercial, financial and agricultural 2		120		149	
Equity lines		79		—	
Consumer		155		71	
Consumer finance		2,132		1,810	
Total recoveries		2,513		2,120	
Net loans charged off		7,237		6,535	
Allowance, end of period	\$	34,990	\$	32,590	
Ratio of annualized net charge-offs to average total loans outstanding during period for Retail Banking and Mortgage Banking		0.87	%	1.02	%
Ratio of annualized net charge-offs to average total loans outstanding during period for Consumer Finance		2.37	%	1.92	%

1 Includes the Corporation's real estate construction lending and consumer real estate lot lending.

2 Includes the Corporation's commercial real estate lending, land acquisition and development lending, builder line lending and commercial business lending.

Table 6 discloses the allocation of the allowance for loan losses at September 30, 2012 and December 31, 2011.

TABLE 6: Allocation of Allowance for Loan Losses

(Dollars in thousands)	September 30, 2012	December 31, 2011
Allocation of allowance for loan losses:		
Real estate—residential mortgage	\$ 2,340	\$ 2,379
Real estate—construction 1	386	480
Commercial, financial and agricultural 2	9,505	10,040
Equity lines	1,001	912
Consumer	345	319

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Consumer finance	21,413	19,547
Balance	\$ 34,990	\$ 33,677

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- 1 Includes the Corporation's real estate construction lending and consumer real estate lot lending.  
2 Includes the Corporation's commercial real estate lending, land acquisition and development lending, builder line lending and commercial business lending.

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Loans by credit quality ratings are presented in Table 7 below. The characteristics of these loan ratings are as follows:

Pass rated loans are to persons or business entities with an acceptable financial condition, appropriate collateral margins, appropriate cash flow to service the existing loan, and an appropriate leverage ratio. The borrower has paid all obligations as agreed and it is expected that this type of payment history will continue. When necessary, acceptable personal guarantors support the loan.

Special mention loans have a specifically identified weakness in the borrower's operations and in the borrower's ability to generate positive cash flow on a sustained basis. The borrower's recent payment history is characterized by late payments. The Corporation's risk exposure is mitigated by collateral supporting the loan. The collateral is considered to be well-margined, well maintained, accessible and readily marketable.

Substandard loans are considered to have specific and well-defined weaknesses that jeopardize the viability of the Corporation's credit extension. The payment history for the loan has been inconsistent and the expected or projected primary repayment source may be inadequate to service the loan. The estimated net liquidation value of the collateral pledged and/or ability of the personal guarantor(s) to pay the loan may not adequately protect the Corporation. There is a distinct possibility that the Corporation will sustain some loss if the deficiencies associated with the loan are not corrected in the near term. A substandard loan would not automatically meet our definition of impaired unless the loan is significantly past due and the borrower's performance and financial condition provide evidence that it is probable that the Corporation will be unable to collect all amounts due.

Substandard nonaccrual loans have the same characteristics as substandard loans; however, they have a nonaccrual classification because it is probable that the Corporation will not be able to collect all amounts due.

Doubtful loans have all the weaknesses inherent in a loan that is classified substandard but 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. The possibility of loss is extremely high.

Loss loans are not considered collectible under normal circumstances and there is no realistic expectation for any future payment on the loan. Loss rated loans are fully charged off.

TABLE 7: Credit Quality Indicators

Loans by credit quality indicators as of September 30, 2012 were as follows:

(Dollars in thousands)	Pass	Special Mention	Substandard	Substandard Nonaccrual	Total <sup>1</sup>
Real estate—residential mortgage	\$ 143,871	\$ 1,131	\$ 2,831	\$ 1,101	\$ 148,934
Real estate—construction <sup>2</sup>	1,761	—	2,867	—	4,628
Commercial, financial and agricultural <sup>3</sup>	175,135	15,009	13,342	13,284	216,770
Equity lines	31,578	1,322	839	48	33,787
Consumer	5,443	—	369	375	6,187
	\$ 357,788	\$ 17,462	\$ 20,248	\$ 14,808	\$ 410,306

(Dollars in thousands)	Performing	Nonperforming	Total
Consumer finance	\$ 270,289	\$ 631	\$ 270,920

1 At September 30, 2012, the Corporation did not have any loans classified as Doubtful or Loss.

2 Includes the Corporation's real estate construction lending and consumer real estate lot lending.

3 Includes the Corporation's commercial real estate lending, land acquisition and development lending, builder line lending and commercial business lending.

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Loans by credit quality indicators as of December 31, 2011 were as follows:

(Dollars in thousands)	Pass	Special Mention	Substandard	Substandard Nonaccrual	Total <sup>1</sup>
Real estate—residential mortgage	\$ 140,304	\$ 1,261	\$ 3,130	\$ 2,440	\$ 147,135
Real estate—construction <sup>2</sup>	2,867	—	2,870	—	5,737
Commercial, financial and agricultural <sup>3</sup>	164,448	18,787	20,931	8,069	212,235
Equity lines	31,935	298	836	123	33,192
Consumer	5,271	10	776	—	6,057
	\$ 344,825	\$ 20,356	\$ 28,543	\$ 10,632	\$ 404,356

(Dollars in thousands)	Performing	Nonperforming	Total
Consumer finance	\$ 245,924	\$ 381	\$ 246,305

- 1 At December 31, 2011, the Corporation did not have any loans classified as Doubtful or Loss.
- 2 Includes the Corporation's real estate construction lending and consumer real estate lot lending.
- 3 Includes the Corporation's commercial real estate lending, land acquisition and development lending, builder line lending and commercial business lending.

The combined Retail Banking and Mortgage Banking segments' allowance for loan losses decreased \$553,000 since December 31, 2011, and the provision for loan losses at these combined segments decreased \$2.7 million during the first nine months of 2012, compared to the same period in 2011. The allowance for loan losses to total loans for these combined segments declined to 3.31 percent at September 30, 2012, compared to 3.49 percent at December 31, 2011. The decline in the allowance ratio occurred during the third quarter of 2012 as a result of loan charge-offs at the Retail Banking segment against previously-established loan loss reserves. Substandard nonaccrual loans increased to \$14.8 million at September 30, 2012 from \$10.6 million at December 31, 2011. The increase since December 31, 2011 was concentrated in the commercial sector of the Retail Banking segment's loan portfolio to which we have allocated the largest portion of the Retail Banking segment's loan loss allowance, and was attributable to one commercial relationship placed on substandard nonaccrual status during the first quarter of 2012 and to one commercial relationship placed on substandard nonaccrual status during the third quarter of 2012, both of which were classified as substandard at December 31, 2011. We believe that the current level of the allowance for loan losses at the combined Retail Banking and Mortgage Banking segments is adequate to absorb any losses on existing loans that may become uncollectible. If current economic conditions continue or worsen, a higher level of nonperforming loans may be experienced in future periods, which may then require a higher provision for loan losses.

The Consumer Finance segment's allowance for loan losses increased to \$21.4 million at September 30, 2012 from \$19.5 million at December 31, 2011, and its provision for loan losses increased \$965,000 during the first nine months of 2012, compared to the same period in 2011. The allowance for loan losses as a percentage of loans at September 30, 2012 was 7.90 percent, as compared with 7.94 percent at December 31, 2011. The increase in the provision for loan losses during the first nine months of 2012 was primarily attributable to higher net charge-offs, the level of which was slightly higher than the historically lower levels we had been experiencing. We believe that the current level of the allowance for loan losses at the Consumer Finance segment is adequate to absorb any losses on existing loans that may become uncollectible. However, if unemployment levels remain elevated or increase in the future, or if consumer demand for automobiles falls and results in declining values of automobiles securing outstanding loans, a higher provision for loan losses may become necessary.

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## Nonperforming Assets

Table 8 summarizes nonperforming assets at September 30, 2012 and December 31, 2011.

TABLE 8: Nonperforming Assets

## Retail Banking and Mortgage Banking Segments

(Dollars in thousands)	September 30, 2012	December 31, 2011
Nonaccrual loans* - Retail Banking	\$ 14,808	\$ 10,011
Nonaccrual loans - Mortgage Banking	—	621
OREO** - Retail Banking	4,621	6,059
OREO** - Mortgage Banking	—	—
Total nonperforming assets	\$ 19,429	\$ 16,691
Accruing loans past due for 90 days or more	\$ 338	\$ 68
Troubled debt restructurings	\$ 17,850	\$ 17,094
Total loans	\$ 410,306	\$ 404,356
Allowance for loan losses	\$ 13,577	\$ 14,130
Nonperforming assets to total loans and OREO*	4.68 %	4.07 %
Allowance for loan losses to total loans	3.31	3.49
Allowance for loan losses to nonaccrual loans	91.69	132.90

\*Nonaccrual loans include nonaccrual TDRs of \$11.40 million at September 30, 2012 and \$8.44 million at December 31, 2011.

\*\* OREO is recorded at its estimated fair value less cost to sell.

## Consumer Finance Segment

(Dollars in thousands)	September 30, 2012	December 31, 2011
Nonaccrual loans	\$ 631	\$ 381
Accruing loans past due for 90 days or more	\$ —	\$ —
Total loans	\$ 270,920	\$ 246,305
Allowance for loan losses	\$ 21,413	\$ 19,547
Nonaccrual consumer finance loans to total consumer finance loans	0.23 %	0.15 %
Allowance for loan losses to total consumer finance loans	7.90	7.94

Nonperforming assets of the combined Retail Banking and Mortgage Banking segments totaled \$19.4 million at September 30, 2012, compared to \$16.7 million at December 31, 2011. Nonperforming assets at September 30, 2012 included \$14.8 million of nonaccrual loans at the Retail Banking segment, compared to \$10.0 million at December 31, 2011, and \$4.6 million of foreclosed, or OREO, properties, compared to \$6.1 million at December 31, 2011. Nonaccrual loans primarily consisted of loans for residential real estate secured by residential properties and commercial loans secured by non-residential properties. The increase in nonaccrual loans from December 31, 2011 to September 30, 2012 was attributable to two commercial relationships secured by undeveloped residential property, which had been classified as substandard at December 31, 2011 and were placed on substandard nonaccrual status

during 2012. The increase in nonaccrual loans attributable to these relationships was partially offset by loan pay-offs, charge-offs and transfers to foreclosed properties. Specific reserves of \$3.0 million have been established for nonaccrual loans. While the ratio of the total allowance for loan losses to nonaccrual loans declined to 91.69 percent at September 30, 2012, compared to 132.90 percent at December 31, 2011, the allowance for nonaccrual loans was \$3.5 million, or 23.6 percent of nonaccrual loans at September 30, 2012, compared to the allowance for nonaccrual loans of \$2.4 million, or 22.6 percent of nonaccrual loans at December 31, 2011. We believe we have provided adequate loan loss reserves based on current appraisals or evaluations of the collateral. In some cases, appraisals have been adjusted to reflect current trends including sales prices, expenses, absorption periods and other current relevant factors. OREO properties at September 30, 2012 primarily consisted of residential and non-residential properties associated with commercial relationships. These properties have been written down to their estimated fair values less cost to sell. The decline in OREO properties since December 31, 2011 resulted from sales during the nine months of 2012 as the Corporation continues to focus efforts on disposing of OREO property, offset in part by transfers from loans to OREO.

Nonaccrual loans at the Consumer Finance segment increased to \$631,000 at September 30, 2012 from \$381,000 at December 31, 2011. As noted above, the allowance for loan losses at the Consumer Finance segment increased from \$19.5 million at December 31, 2011 to \$21.4 million at September 30, 2012, and the ratio of the allowance for loan losses to total consumer finance loans was 7.90 percent as of September 30, 2012, as compared with 7.94 percent at December 31, 2011. Nonaccrual consumer finance loans remain

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relatively low compared to the allowance for loan losses and the total consumer finance loan portfolio because the Consumer Finance segment generally initiates repossession of loan collateral once a loan is 60 days or more past due but before the loan reaches 90 days or more past due and is evaluated for nonaccrual status.

We measure impaired loans based on the present value of expected future cash flows discounted at the effective interest rate of the loan 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. We maintain a valuation allowance to the extent that the measure of the impaired loan is less than the recorded investment. TDRs occur when we agree to significantly modify the original terms of a loan by granting a concession due to the deterioration in the financial condition of the borrower. These concessions typically are made for loss mitigation purposes and could include reductions in the interest rate, payment extensions, forgiveness of principal, forbearance or other actions. TDRs are considered impaired loans.

TABLE 9: Impaired Loans

Impaired loans, which include TDRs of \$17.9 million, and the related allowance at September 30, 2012, were as follows:

(Dollars in thousands)	Recorded Investment in Loans	Unpaid Principal Balance	Related Allowance	Average Balance-Impaired Loans	Interest Income Recognized
Real estate – residential mortgage	\$ 2,249	\$2,294	\$438	\$ 2,278	\$30
Real estate – construction:					
Construction lending	—	—	—	—	—
Consumer lot lending	—	—	—	—	—
Commercial, financial and agricultural:					
Commercial real estate lending	8,710	8,982	1,737	9,159	62
Land acquisition and development lending	7,460	7,860	1,732	8,176	59
Builder line lending	511	1,411	—	1,589	—
Commercial business lending	627	631	55	638	3
Equity lines	—	—	—	—	—
Consumer	323	323	48	324	4
Total	\$ 19,880	\$21,501	\$4,010	\$ 22,164	\$158

Impaired loans, which include TDRs of \$17.1 million, and the related allowance at December 31, 2011, were as follows:

(Dollars in thousands)	Recorded Investment in Loans	Unpaid Principal Balance	Related Allowance	Average Balance-Impaired Loans	Interest Income Recognized
Real estate – residential mortgage	\$ 3,482	\$3,698	\$657	\$ 3,723	\$137
Commercial, financial and agricultural:					
Commercial real estate lending	5,861	5,957	1,464	6,195	102
Land acquisition and development lending	5,490	5,814	1,331	6,116	372
Builder line lending	2,285	2,285	318	2,397	—
Commercial business lending	652	654	161	663	6
Equity lines	—	—	—	—	—
Consumer	324	324	49	324	14
Total	\$ 18,094	\$18,732	\$3,980	\$ 19,418	\$631



The balance of impaired loans was \$19.9 million, including \$17.9 million of TDRs at September 30, 2012, for which there were specific valuation allowances of \$4.0 million. At December 31, 2011, the balance of impaired loans was \$18.1 million, including \$17.1 million of TDRs, for which there were specific valuation allowances of \$4.0 million. The Corporation has no obligation to fund additional advances on its impaired loans.

While period-end TDRs increased only slightly from \$17.1 million at December 31, 2011 to \$17.9 million at September 30, 2012, loan modifications that were classified as TDRs during the first nine months of 2012 totaled \$4.5 million and consisted primarily of one \$3.9 million commercial relationship, which was offset in part by scheduled payments, pay-offs and charge-offs. As the Retail Banking segment's loan portfolio remains under credit quality pressure, the Corporation may use loan modifications as a responsible approach to managing asset quality when working with borrowers who are experiencing financial difficulty, which may result in additional TDRs.

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TDRs at September 30, 2012 and December 31, 2011 were as follows:

TABLE 10: Troubled Debt Restructurings

(Dollars in thousands)	September 30, 2012	December 31, 2011
Accruing TDRs	\$6,446	\$ 8,653
Nonaccrual TDRs <sup>1</sup>	11,404	8,441
Total TDRs <sup>2</sup>	\$17,850	\$ 17,094

1 Included in nonaccrual loans in Table 8: Nonperforming Assets.

2 Included in impaired loans in Table 9: Impaired Loans.

While TDRs are considered impaired loans, not all TDRs are on nonaccrual status. If a loan was on nonaccrual status at the time of the TDR modification, the loan will remain on nonaccrual status following the modification and may be returned to accrual status based on the Corporation's policy for returning loans to accrual status. If a loan was accruing prior to being modified as a TDR and if the Corporation concludes that the borrower is able to make such modified payments, and there are no other factors or circumstances that would cause it to conclude otherwise, the TDR will remain on an accruing status.

## FINANCIAL CONDITION

At September 30, 2012, the Corporation had total assets of \$961.8 million compared to \$928.1 million at December 31, 2011. The increase was principally a result of loan growth at the Retail Banking and Consumer Finance segments and an increase in loans held for sale at the Mortgage Banking segment, which were offset in part by a decline in the Retail Banking segment's securities portfolio resulting from maturities and calls during the first nine months of 2012.

## Loan Portfolio

The following table sets forth the composition of the Corporation's loans held for investment in dollar amounts and as a percentage of the Corporation's total gross loans held for investment at the dates indicated.

TABLE 11: Summary of Loans Held for Investment

(Dollars in thousands)	September 30, 2012		December 31, 2011		
	Amount	Percent	Amount	Percent	%
Real estate – residential mortgage	\$148,934	22	\$147,135	22	%
Real estate – construction <sup>1</sup>	4,628	1	5,737	1	
Commercial, financial and agricultural <sup>2</sup>	216,770	32	212,235	33	
Equity lines	33,787	5	33,192	5	
Consumer	6,187	1	6,057	1	
Consumer finance	270,920	39	246,305	38	
Total loans	681,226	100	650,661	100	%
Less allowance for loan losses	(34,990 )		(33,677 )		
Total loans, net	\$646,236		\$616,984		

- 
- 1 Includes the Corporation's real estate construction lending and consumer real estate lot lending.  
2 Includes the Corporation's commercial real estate lending, land acquisition and development lending, builder line lending and commercial business lending.

The increase in total loans held for investment primarily occurred in the commercial, financial and agricultural segment as a result of growth in commercial real estate loans and in the consumer finance category as a result of increased demand for automobiles and increased market penetration.

#### Investment Securities

The investment portfolio plays a primary role in the management of the Corporation's interest rate sensitivity. In addition, the portfolio serves as a source of liquidity and is used as needed to meet collateral requirements. The investment portfolio consists of securities available for sale, which may be sold in response to changes in market interest rates, changes in prepayment risk, changes in

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loan demand, general liquidity needs and other similar factors. These securities are carried at estimated fair value. At September 30, 2012 and December 31, 2011, all securities in the Corporation's investment portfolio were classified as available for sale.

The following table sets forth the composition of the Corporation's securities available for sale at fair value and as a percentage of the Corporation's total securities available for sale at the dates indicated.

TABLE 12: Securities Available for Sale

(Dollars in thousands)	September 30, 2012		December 31, 2011		
	Amount	Percent	Amount	Percent	
U.S. government agencies and corporations	\$12,730	9	% \$15,283	10	%
Mortgage-backed securities	2,464	2	2,216	2	
Obligations of states and political subdivisions	125,374	89	127,079	88	
Total debt securities	140,568	100	144,578	100	
Preferred stock	40	*	68	*	
Total available for sale securities at fair value	\$140,608	100	% \$144,646	100	%

\* Less than one percent.

**Deposits**

The Corporation's predominant source of funds is depository accounts, which consist of demand deposits, savings and money market accounts, and time deposits. The Corporation's deposits are principally provided by individuals and businesses located within the communities served.

Deposits totaled \$664.2 million at September 30, 2012, compared to \$646.4 million at December 31, 2011. The increase from December 31, 2011 occurred primarily in noninterest-bearing demand deposits, which increased \$21.1 million, or 22.1 percent, from December 31, 2011 to September 30, 2012, due to higher account balances for both personal and business depositors. Savings and interest-bearing demand deposits increased \$12.1 million, or 5.0 percent, since December 31, 2011, while time deposits declined \$15.3 million, or 5.0 percent, since December 31, 2011. This shift in the mix of deposits to shorter-term, lower rate interest-bearing demand deposits has occurred as depositors are positioning for flexibility in the availability of their funds in the event of an upward shift in interest rates. The Corporation had \$2.3 million in brokered money market deposits outstanding at September 30, 2012, compared to no brokered deposits at December 31, 2011. The source of these brokered deposits is uninvested cash balances held in third-party brokerage sweep accounts. The Corporation uses brokered deposits as a means of diversifying liquidity sources, as opposed to a long-term deposit gathering strategy.

**Borrowings**

Borrowings totaled \$171.0 million at September 30, 2012, compared to \$161.2 million at December 31, 2011, as the Corporation used short-term borrowings to meet the short-term funding needs at the Mortgage Banking segment.

**Off-Balance Sheet Arrangements**

As of September 30, 2012, there have been no material changes to the off-balance sheet arrangements disclosed in "Management's Discussion and Analysis" in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2011.

### Contractual Obligations

As of September 30, 2012, there have been no material changes outside the ordinary course of business to the contractual obligations disclosed in “Management’s Discussion and Analysis” in the Corporation’s Annual Report on Form 10-K for the year ended December 31, 2011.

### Liquidity

The objective of the Corporation’s liquidity management is to ensure the continuous availability of funds to satisfy the credit needs of our customers and the demands of our depositors, creditors and investors. Stable core deposits and a strong capital position are the foundation for the Corporation’s liquidity position. Additional sources of liquidity available to the Corporation include cash flows from operations, loan payments and payoffs, deposit growth, sales of securities, the issuance of brokered certificates of deposit and the capacity to borrow additional funds.

Liquid assets, which include cash and due from banks, interest-bearing deposits at other banks, federal funds sold and nonpledged securities available for sale, at September 30, 2012 totaled \$54.5 million, compared to \$49.2 million at December 31, 2011. The

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Corporation's funding sources, including the capacity, amount outstanding and amount available at September 30, 2012 are presented in Table 13: Funding Sources.

TABLE 13: Funding Sources

(Dollars in thousands)	September 30, 2012		
	Capacity	Outstanding	Available
Federal funds purchased	\$59,000	\$ 10,000	\$49,000
Repurchase agreements	5,000	5,000	—
Borrowings from FHLB	95,856	52,500	43,356
Borrowings from Federal Reserve Bank	48,211	—	48,211
Revolving line of credit	120,000	75,487	44,513
Total	\$328,067	\$ 142,987	\$ 185,080

We have no reason to believe these arrangements will not be renewed at maturity. Additional loans and securities are also available that can be pledged as collateral for future borrowings from the Federal Reserve Bank and the FHLB above the current lendable collateral value. From December 31, 2011 to September 30, 2012, the Corporation's available funding from the sources identified in Table 13 decreased from \$221.9 million to \$185.1 million. This decline resulted primarily from the utilization of federal funds purchased to meet the short-term funding needs of the Mortgage Banking segment and from a decline in the loans pledged to the FHLB. We do not believe this decrease represents a material change to our liquidity position, and the Corporation may pledge additional loans to increase its funding at the FHLB.

As a result of the Corporation's management of liquid assets and the ability to generate liquidity through liability funding, management believes that the Corporation maintains overall liquidity sufficient to satisfy its operational requirements and contractual obligations.

## Capital Resources

The Corporation's and the Bank's actual capital amounts and ratios are presented in the following table.

TABLE 14: Capital Ratios

(Dollars in thousands)	Actual		Minimum Capital Requirements		Minimum To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
As of September 30, 2012:						
Total Capital (to Risk-Weighted Assets)						
Corporation	\$ 114,782	16.1	% \$57,178	8.0	% N/A	N/A
Bank	112,380	15.8	56,979	8.0	\$71,224	10.0 %
Tier 1 Capital (to Risk-Weighted Assets)						
Corporation	105,527	14.8	28,589	4.0	N/A	N/A
Bank	103,155	14.5	28,490	4.0	42,734	6.0

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Tier 1 Capital (to Average Assets)

Corporation	105,527	11.3	37,508	4.0	N/A	N/A
Bank	103,155	11.0	37,402	4.0	46,752	5.0

As of December 31, 2011:

Total Capital (to

Risk-Weighted Assets)

Corporation	\$113,427	16.4	% \$55,205	8.0	% N/A	N/A
Bank	111,029	16.2	54,999	8.0	\$68,749	10.0 %

Tier 1 Capital (to

Risk-Weighted Assets)

Corporation	104,492	15.1	27,603	4.0	N/A	N/A
Bank	102,126	14.9	27,500	4.0	41,249	6.0

Tier 1 Capital (to Average Assets)

Corporation	104,492	11.5	36,362	4.0	N/A	N/A
Bank	102,126	11.3	36,252	4.0	45,315	5.0

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On April 11, 2012, the Corporation redeemed the remaining 10,000 shares of its Preferred Stock issued to Treasury in January 2009 under the CPP. The redemption consisted of \$10.0 million in liquidation value and \$78,000 of accrued and unpaid dividends associated with the Preferred Stock. As a result of this redemption, the Corporation will pay no future dividends on the Preferred Stock. Further, in connection with this redemption, the Corporation accelerated the accretion of the remaining preferred stock discount, which reduced net income available to common shareholders by approximately \$151,000 in the second quarter of 2012, but eliminated any future accretion.

The Corporation's Tier One Capital and Total Capital presented in Table 14 include \$20.0 million of trust preferred securities. The Federal Reserve Board, acting in concert with the other federal banking regulatory agencies, has published proposed rules that, if adopted, would generally implement the Basel III capital standards and impose upon bank holding companies with under \$15 billion in total consolidated assets a ten-year phase-out period for trust preferred securities from Tier 1 capital. The Corporation anticipates that the Federal Reserve Board will adopt a final version of these proposed rules in the near future.

### Effects of Inflation and Changing Prices

The Corporation's financial statements included herein have been prepared in accordance with accounting principles generally accepted in the United States (GAAP). GAAP presently requires the Corporation to measure financial position and operating results primarily in terms of historic dollars. Changes in the relative value of money due to inflation or recession are generally not considered. The primary effect of inflation on the operations of the Corporation is reflected in increased operating costs. In management's opinion, changes in interest rates affect the financial condition of a financial institution to a far greater degree than changes in the inflation rate. While interest rates are greatly influenced by changes in the inflation rate, they do not necessarily change at the same rate or in the same magnitude as the inflation rate. Interest rates are highly sensitive to many factors that are beyond the control of the Corporation, including changes in the expected rate of inflation, the influence of general and local economic conditions and the monetary and fiscal policies of the United States government, its agencies and various other governmental regulatory authorities.

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

There have been no significant changes from the quantitative and qualitative disclosures made in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2011.

### ITEM 4. CONTROLS AND PROCEDURES

The Corporation's management, including the Corporation's Chief Executive Officer and the Chief Financial Officer, has evaluated the effectiveness of the Corporation's disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)) as of the end of the period covered by this report. Based on that evaluation, the Chief Executive Officer and the Chief Financial Officer have concluded that the Corporation's disclosure controls and procedures were effective as of September 30, 2012 to ensure that information required to be disclosed by the Corporation in reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms and that such information is accumulated and communicated to the Corporation's management, including the Corporation's Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that the Corporation's disclosure controls and procedures will detect or uncover every situation involving the failure of persons within the Corporation or its subsidiary to disclose material information required to be set forth in the Corporation's periodic reports.



Management of the Corporation is also responsible for establishing and maintaining adequate internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act). There were no changes in the Corporation's internal control over financial reporting during the Corporation's third quarter ended September 30, 2012 that have materially affected, or are reasonably likely to materially affect, the Corporation's internal control over financial reporting.

PART II - OTHER INFORMATION

ITEM 1A.

RISK FACTORS

There have been no material changes in the risk factors faced by the Corporation from those disclosed in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2011.

ITEM 2.

UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

There have been no purchases of the Corporation's Common Stock during 2012.

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ITEM 6.

EXHIBITS

3.1	Articles of Incorporation of C&F Financial Corporation (incorporated by reference to Exhibit 3.1 to Form 10-KSB filed March 29, 1996)
3.1.1	Amendment to Articles of Incorporation of C&F Financial Corporation establishing Series A Preferred Stock, effective January 8, 2009 (incorporated by reference to Exhibit 3.1.1 to Form 8-K filed January 14, 2009)
3.2	Amended and Restated Bylaws of C&F Financial Corporation, as adopted October 16, 2007 (incorporated by reference to Exhibit 3.2 to Form 8-K filed October 22, 2007)
4.1	Certificate of Designations for 20,000 shares of Fixed Rate Cumulative Perpetual Preferred Stock, Series A (incorporated by reference to Exhibit 3.1.1 to Form 8-K filed January 14, 2009)
4.2	Warrant to Purchase up to 167,504 shares of Common Stock, dated January 9, 2009 (incorporated by reference to Exhibit 4.2 to Form 8-K filed January 14, 2009)
<u>10.19.2</u>	Second Amendment to Amended and Restated Loan and Security Agreement by and among Wells Fargo Bank, N.A., various financial institutions and C&F Finance Company dated as of September 17, 2012
<u>31.1</u>	Certification of CEO pursuant to Rule 13a-14(a)
<u>31.2</u>	Certification of CFO pursuant to Rule 13a-14(a)
<u>32</u>	Certification of CEO/CFO pursuant to 18 U.S.C. Section 1350
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB	XBRL Taxonomy Extension Label Linkbase Document
101.PRE	XBRL Taxonomy Presentation Linkbase Document

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

C&F FINANCIAL CORPORATION  
(Registrant)

Date November 7, 2012

/s/ Larry G. Dillon  
Larry G. Dillon  
Chairman, President and Chief Executive  
Officer  
(Principal Executive Officer)

Date November 7, 2012

/s/ Thomas F. Cherry  
Thomas F. Cherry  
Executive Vice President,  
Chief Financial Officer and Secretary  
(Principal Financial and Accounting  
Officer)