FIDELITY SOUTHERN CORP
Form 10-Q
August 06, 2010

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**UNITED STATES**
**SECURITIES AND EXCHANGE COMMISSION**
**Washington, D.C. 20549**
**FORM 10-Q**

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

**For the quarterly period ended June 30, 2010**
**Commission File Number: 0-22374**
**Fidelity Southern Corporation**
(Exact name of registrant as specified in its charter)

| | |
|---|---|
| Georgia | 58-1416811 |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |
| 3490 Piedmont Road, Suite 1550, Atlanta GA | 30305 |
| (Address of principal executive offices) | (Zip Code) |

(404) 639-6500
(Registrant s telephone number, including area code)
(Former name, former address and former fiscal year, if changed since last report)

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

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

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

| | | | |
|---|---|---|---|
| Large accelerated filer o | Accelerated filer o | Non-accelerated filer o (Do not check if a Smaller Reporting Company) | Smaller Reporting Company þ |

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

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

| Class | Shares Outstanding at July 31, 2010 |
|---|---|
| Common Stock, no par value | 10,600,436 |

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## PART I FINANCIAL INFORMATION
### Item 1. *Financial Statements*
### FIDELITY SOUTHERN CORPORATION AND SUBSIDIARIES
### CONSOLIDATED BALANCE SHEETS

| | (Unaudited) June 30, 2010 | December 31, 2009 |
|---|---|---|
| | *(Dollars in Thousands)* | |
| **Assets** | | |
| Cash and due from banks | $ 108,898 | $ 168,766 |
| Interest-bearing deposits with banks | 1,760 | 1,926 |
| Federal funds sold | 519 | 428 |
| Cash and cash equivalents | 111,177 | 171,120 |
| Investment securities available-for-sale (amortized cost of $162,047 and $137,020 at June 30, 2010, and December 31, 2009, respectively) | 164,082 | 136,917 |
| Investment securities held-to-maturity (approximate fair value of $18,053 and $19,942 at June 30, 2010, and December 31, 2009, respectively) | 16,896 | 19,326 |
| Investment in FHLB stock | 6,857 | 6,767 |
| Loans held-for-sale (loans at fair value: $134,962 at June 30, 2010; $80,869 at December 31, 2009) | 183,672 | 131,231 |
| Loans | 1,308,991 | 1,289,859 |
| Allowance for loan losses | (27,104) | (30,072) |
| Loans, net of allowance for loan losses | 1,281,887 | 1,259,787 |
| Premises and equipment, net | 18,795 | 18,092 |
| Other real estate, net | 22,225 | 21,780 |
| Accrued interest receivable | 7,992 | 7,832 |
| Bank owned life insurance | 29,663 | 29,058 |
| Other assets | 41,355 | 49,610 |
| Total assets | $ 1,884,601 | $ 1,851,520 |
| **Liabilities** | | |
| Deposits: | | |
| Noninterest-bearing demand deposits | $ 172,919 | $ 157,511 |
| Interest-bearing deposits: | | |
| Demand and money market | 336,983 | 252,493 |
| Savings | 435,267 | 440,596 |
| Time deposits, $100,000 and over | 211,550 | 257,450 |
| Other time deposits | 406,902 | 442,675 |
| Total deposits | 1,563,621 | 1,550,725 |
| Other short-term borrowings | 49,902 | 41,870 |
| Subordinated debt | 67,527 | 67,527 |
| Other long-term debt | 50,000 | 50,000 |

| | | |
|---|---|---|
| Accrued interest payable | 3,708 | 4,504 |
| Other liabilities | 12,700 | 7,209 |
| Total liabilities | 1,747,458 | 1,721,835 |
| **Shareholders Equity** | | |
| Preferred stock, no par value. Authorized 10,000,000; 48,200 shares issued and outstanding | 45,137 | 44,696 |
| Common stock, no par value. Authorized 50,000,000; issued and outstanding 10,599,293 and 10,116,693 at June 30, 2010, and December 31, 2009, respectively | 56,091 | 53,342 |
| Accumulated other comprehensive income (loss), net of taxes | 1,261 | (64) |
| Retained earnings | 34,654 | 31,711 |
| Total shareholders equity | 137,143 | 129,685 |
| Total liabilities and shareholders equity | $ 1,884,601 | $ 1,851,520 |

*See accompanying notes to consolidated financial statements.*

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**FIDELITY SOUTHERN CORPORATION AND SUBSIDIARIES**
**CONSOLIDATED STATEMENTS OF OPERATIONS**
**(UNAUDITED)**

| | Six Months Ended June 30, 2010 | Six Months Ended June 30, 2009 | Three Months Ended June 30, 2010 | Three Months Ended June 30, 2009 |
|---|---|---|---|---|
| | *(Dollars in Thousands, except per share data)* | | | |
| **Interest income** | | | | |
| Loans, including fees | $ 42,818 | $ 42,904 | $ 21,754 | $ 21,693 |
| Investment securities | 4,748 | 5,072 | 2,673 | 2,981 |
| Federal funds sold and bank deposits | 106 | 62 | 13 | 32 |
| Total interest income | 47,672 | 48,038 | 24,440 | 24,706 |
| **Interest expense** | | | | |
| Deposits | 13,225 | 21,170 | 6,349 | 10,685 |
| Short-term borrowings | 713 | 378 | 381 | 188 |
| Subordinated debt | 2,240 | 2,384 | 1,123 | 1,181 |
| Other long-term debt | 689 | 1,062 | 346 | 603 |
| Total interest expense | 16,867 | 24,994 | 8,199 | 12,657 |
| **Net interest income** | 30,805 | 23,044 | 16,241 | 12,049 |
| Provision for loan losses | 5,125 | 16,800 | 1,150 | 7,200 |
| **Net interest income after provision for loan losses** | 25,680 | 6,244 | 15,091 | 4,849 |
| **Noninterest income** | | | | |
| Service charges on deposit accounts | 2,219 | 2,126 | 1,171 | 1,103 |
| Other fees and charges | 1,043 | 977 | 559 | 506 |
| Mortgage banking activities | 7,800 | 8,257 | 4,525 | 4,649 |
| Indirect lending activities | 2,197 | 2,195 | 1,161 | 1,051 |
| SBA lending activities | 846 | 437 | 734 | 259 |
| Bank owned life insurance | 656 | 627 | 330 | 329 |
| Securities gains | 2,291 | | 2,291 | |
| Other | 703 | (49) | 477 | (142) |
| Total noninterest income | 17,755 | 14,570 | 11,248 | 7,755 |
| **Noninterest expense** | | | | |
| Salaries and employee benefits | 18,905 | 16,842 | 10,021 | 8,950 |
| Furniture and equipment | 1,318 | 1,346 | 674 | 691 |
| Net occupancy | 2,215 | 2,182 | 1,125 | 1,103 |
| Communication | 919 | 765 | 475 | 415 |
| Professional and other services | 2,112 | 2,336 | 1,074 | 1,263 |

| | | | | |
|---|---|---|---|---|
| Cost of operation of other real estate | 4,527 | 2,689 | 2,358 | 1,940 |
| FDIC insurance premiums | 1,767 | 1,879 | 881 | 1,556 |
| Other | 4,054 | 3,485 | 2,215 | 1,586 |
| Total noninterest expense | 35,817 | 31,524 | 18,823 | 17,504 |
| Income (loss) before income tax benefit | 7,618 | (10,710) | 7,516 | (4,900) |
| Income tax expense (benefit) | 2,554 | (4,529) | 2,647 | (2,095) |
| **Net income (loss)** | 5,064 | (6,181) | 4,869 | (2,805) |
| Preferred stock dividends | (1,646) | (1,646) | (823) | (823) |
| Net income (loss) available to common equity | $ 3,418 | $ (7,827) | $ 4,046 | $ (3,628) |
| Earnings (loss) per share: | | | | |
| Basic earnings (loss) per share | $ .33 | $ (.78) | $ .38 | $ (.36) |
| Diluted earnings (loss) per share | $ .29 | $ (.78) | $ .34 | $ (.36) |
| Weighted average common shares outstanding-basic | 10,461,335 | 10,050,450 | 10,616,533 | 10,106,205 |
| Weighted average common shares outstanding-fully diluted | 11,718,941 | 10,050,450 | 12,076,624 | 10,106,205 |

*See accompanying notes to consolidated financial statements.*

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**FIDELITY SOUTHERN CORPORATION AND SUBSIDIARIES**
**CONSOLIDATED STATEMENTS OF CASH FLOWS**
**(UNAUDITED)**

| | Six Months Ended June 30, 2010 | Six Months Ended June 30, 2009 |
|---|---|---|
| | *(In Thousands)* | |
| **Operating Activities** | | |
| Net income (loss) | $ 5,064 | $ (6,181) |
| Adjustments to reconcile net loss to net cash used in operating activities: | | |
| Provision for loan losses | 5,125 | 16,800 |
| Depreciation and amortization of premises and equipment | 876 | 984 |
| Other amortization | 933 | 354 |
| Reserve for impairment of other real estate | 2,881 | 1,980 |
| Share-based compensation | 59 | 128 |
| Proceeds from sales of loans | 442,345 | 371,719 |
| Proceeds from sales of other real estate | 7,080 | 4,933 |
| Loans originated for resale | (489,222) | (481,056) |
| Gain on loan sales | (5,564) | (3,949) |
| Gain on sales of investment securities | (2,291) | |
| (Gain) loss on sales of other real estate | (386) | 432 |
| Increase in cash value of bank owned life insurance | (605) | (580) |
| Net decrease (increase) in deferred income taxes | 1,012 | (1,660) |
| Changes in assets and liabilities which provided (used) cash: | | |
| Accrued interest receivable | (160) | (287) |
| Other assets | 6,033 | (2,713) |
| Accrued interest payable | (796) | (1,146) |
| Other liabilities | 5,491 | 2,112 |
| Net cash used in operating activities | (22,125) | (98,130) |
| **Investing Activities** | | |
| Purchases of investment securities available-for-sale | (196,547) | (128,422) |
| Purchases of investment in FHLB stock | (90) | (1,485) |
| Proceeds from sale of investment securities held-for-sale | 100,633 | |
| Maturities and calls of investment securities held-to-maturity | 2,434 | 2,810 |
| Maturities and calls of investment securities available-for-sale | 72,638 | 20,286 |
| Net (increase) decrease in loans | (37,230) | 42,388 |
| Capital improvements to other real estate | (15) | (179) |
| Purchases of premises and equipment | (1,579) | (361) |
| Net cash used in investing activities | (59,756) | (64,963) |
| **Financing Activities** | | |
| Net increase in transactional accounts | 94,569 | 155,965 |
| Net decrease in time deposits | (81,673) | (33,705) |
| Proceeds of issuance of other long-term debt | | 30,000 |

| | | | | |
|---|---|---|---|---|
| Repayment of other long-term debt | | | | (2,500) |
| Net increase (decrease) in short-term borrowings | | 8,032 | | (12,254) |
| Dividends paid | | (3) | | (1) |
| Proceeds from the issuance of common stock | | 2,218 | | 423 |
| Preferred stock dividends paid | | (1,205) | | (978) |
| Net cash provided by financing activities | | 21,938 | | 136,950 |
| Net decrease in cash and cash equivalents | | (59,943) | | (26,143) |
| Cash and cash equivalents, beginning of period | | 171,120 | | 92,025 |
| Cash and cash equivalents, end of period | $ | 111,177 | $ | 65,882 |
| Supplemental disclosures of cash flow information: | | | | |
| Cash paid (refunded) during the period for: | | | | |
| Interest | $ | 17,663 | $ | 26,140 |
| Income taxes | $ | (951) | $ | (3,321) |
| Non-cash transfers to other real estate | $ | 10,005 | $ | 17,128 |
| Stock dividend | $ | 472 | $ | 122 |
| Accrued but unpaid dividend on preferred stock | $ | 308 | $ | 308 |
| Accretion on U.S. Treasury preferred stock | $ | 441 | $ | 441 |
| Loans transferred from held-for-sale | $ | 3,884 | $ | |

*See accompanying notes to consolidated financial statements.*

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**FIDELITY SOUTHERN CORPORATION AND SUBSIDIARIES**
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**
**(UNAUDITED)**
**JUNE 30, 2010**

**1. Basis of Presentation**

The accompanying unaudited consolidated financial statements include the accounts of Fidelity Southern Corporation and its wholly owned subsidiaries ( Fidelity ). Fidelity Southern Corporation ( FSC ) owns 100% of Fidelity Bank (the Bank ), and LionMark Insurance Company, an insurance agency offering consumer credit related insurance products. FSC also owns five subsidiaries established to issue trust preferred securities, which entities are not consolidated for financial reporting purposes in accordance with Accounting Standards Codification ( ASC ) 942-810-55, as FSC is not the primary beneficiary. The Company , as used herein, includes FSC and its subsidiaries, unless the context otherwise requires.

These unaudited consolidated financial statements have been prepared in conformity with U.S. generally accepted accounting principles followed within the financial services industry for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and notes required for complete financial statements.

In preparing the consolidated financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the balance sheet and revenues and expenses for the periods covered by the statements of operations. Actual results could differ significantly 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 valuation of mortgage loans held-for-sale, the calculations of and the amortization of capitalized servicing rights, the valuation of net deferred income taxes and the valuation of real estate or other assets acquired in connection with foreclosures or in satisfaction of loans. In addition, the actual lives of certain amortizable assets and income items are estimates subject to change. The Company principally operates in one business segment, which is community banking.

In the opinion of management, all adjustments considered necessary for a fair presentation of the financial position and results of operations for the interim periods have been included. All such adjustments are normal recurring accruals. Certain previously reported amounts have been reclassified to conform to current presentation. These reclassifications had no impact on previously reported net income, or shareholders equity or cash flows. The Company s significant accounting policies are described in Note 1 of the Notes to Consolidated Financial Statements included in our 2009 Annual Report on Form 10-K filed with the Securities and Exchange Commission. There were no new accounting policies or changes to existing policies adopted in the first six months of 2010, which had a significant effect on the results of operations or statement of financial condition. For interim reporting purposes, the Company follows the same basic accounting policies and considers each interim period as an integral part of an annual period.

Operating results for the six month period ended June 30, 2010, are not necessarily indicative of the results that may be expected for the year ended December 31, 2010. These statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company s Annual Report on Form 10-K and Annual Report to Shareholders for the year ended December 31, 2009.

**2. Shareholders Equity**

The Board of Governors of the Federal Reserve System (the FRB ) is the primary regulator of FSC, a bank holding company. The Bank is a state chartered commercial bank subject to Federal and state statutes applicable to banks chartered under the banking laws of the State of Georgia and to banks whose deposits are insured by the Federal Deposit Insurance Corporation (the FDIC ), the Bank s primary Federal regulator. The Bank is a wholly owned subsidiary of the Company. The Bank s state regulator is the Georgia Department of Banking and Finance (the GDBF ). The FDIC and the GDBF examine and evaluate the financial condition, operations, and policies and procedures of state chartered commercial banks, such as the Bank, as part of their legally prescribed oversight responsibilities.

The FRB, FDIC, and GDBF have established capital adequacy requirements as a function of their oversight of bank holding companies and state chartered banks. Each bank holding company and each bank must maintain certain minimum capital ratios. At June 30, 2010, and December 31, 2009, the Company exceeded all capital ratios required by the FRB, FDIC, and GDBF to be considered well capitalized. In addition, the Bank s Tier 1 leverage ratio of 9.57% exceeded the 8% minimum required by memoranda of understanding executed in 2009 between FSC, the Bank, the FDIC, the FRB, and the GDBF.

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Earnings per share were calculated as follows:

| | For the Quarter Ended June 30, | |
|---|---|---|
| | 2010 | 2009 |
| | (Dollars in Thousands, except per share data) | |
| Net income (loss) | $ 4,869 | $ (2,805) |
| Less dividends on preferred stock and accretion of discount | (823) | (823) |
| Net income (loss) available to common equity | $ 4,046 | $ (3,628) |
| Average common shares outstanding | 10,511 | 9,808 |
| Effect of stock dividends | 106 | 298 |
| Average common shares outstanding basic | 10,617 | 10,106 |
| Dilutive stock options and warrants | 1,460 | |
| Average common shares outstanding dilutive | 12,077 | 10,106 |
| Earnings (loss) per share basic | $ .38 | $ (.36) |
| Earnings (loss) per share dilutive | $ .34 | $ (.36) |

| | For the Six Months Ended June 30, | |
|---|---|---|
| | 2010 | 2009 |
| | (Dollars in Thousands, except per share data) | |
| Net income (loss) | $ 5,064 | $ (6,181) |
| Less dividends on preferred stock and accretion of discount | (1,646) | (1,646) |
| Net income (loss) available to common equity | $ 3,418 | $ (7,827) |
| Average common shares outstanding | 10,357 | 9,754 |
| Effect of stock dividends | 104 | 296 |
| Average common shares outstanding basic | 10,461 | 10,050 |
| Dilutive stock options and warrants | 1,258 | |
| Average common shares outstanding dilutive | 11,719 | 10,050 |
| Earnings (loss) per share basic | $ .33 | $ (.78) |
| Earnings (loss) per share dilutive | $ .29 | $ (.78) |

**3. Contingencies**

Due to the nature of their activities, the Company and its subsidiaries are at times engaged in various legal proceedings that arise in the course of normal business, some of which were outstanding as of June 30, 2010. While it is difficult to predict or determine the outcome of these proceedings, it is the opinion of management, after consultation with its legal counsel, that the ultimate liabilities, if any, will not have a material adverse impact on the Company s consolidated results of operations, financial position, or cash flows.

**4. Comprehensive Income (Loss)**

Comprehensive income (loss) includes net income (loss) and other comprehensive income (loss), related to unrealized gains and losses on investment securities classified as available-for-sale. All other comprehensive income (loss) items are tax effected at a rate of 38% for each period.

During the second quarter and first six months of 2010, other comprehensive income net of tax was $943,000 and $1.3 million, respectively. Other comprehensive income, net of tax, was $1.1 million and $69,000 for the comparable periods in 2009. Comprehensive income for the second quarter and first six months of 2010 was $5.8 million and $6.4 million compared to comprehensive loss of $(3.9) million and $(6.3) million for the same period in 2009.

**5. Share-Based Compensation**

The Company s 1997 Stock Option Plan authorized the grant of options to management personnel for up to 500,000 shares of the Company s common stock. All options granted have three year to eight year terms and vest and become fully exercisable at the end of three years to five years of continued employment. No options may be or were granted after June 30, 2007, under this plan.

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The Fidelity Southern Corporation Equity Incentive Plan (the 2006 Incentive Plan ), permits the grant of stock options, stock appreciation rights, restricted stock, restricted stock units, and other incentive awards ( Incentive Awards ). The maximum number of shares of the Company s common stock that may be issued under the 2006 Incentive Plan is 750,000 shares, all of which may be stock options. Generally, no award shall be exercisable or become vested or payable more than 10 years after the date of grant. Options granted under the 2006 Incentive Plan have four year terms and become fully exercisable at the end of three years of continued employment. Incentive awards available under the 2006 Incentive Plan totaled 152,571 shares at June 30, 2010.

In the first quarter of 2010, FSC granted 154,078 restricted shares of common stock under the 2006 Equity Incentive Plan to certain employees. The stock was granted at $4.50 per share, vests 40% over two years and then 20% per year through five years and will be fully vested after January 22, 2015. The restricted stock is subject to section 111 of the Emergency Economic Stabilization Act of 2008, as amended by the American Recovery and Reinvestment Act of 2009 and regulations issued by the Department of the Treasury. At June 30, 2010, there was $624,000 in remaining unrecognized compensation cost related to the restricted stock.

A summary of option activity as of June 30, 2010, and changes during the six month period then ended is presented below:

| | Number of share options | Weighted Average Exercise Price | Weighted Average Remaining Contractual Terms | Aggregate Intrinsic Value |
|---|---|---|---|---|
| Outstanding at January 1, 2010 | 494,405 | $ 8.59 | | |
| Granted | | | | |
| Exercised | | | | |
| Forfeited | 1,000 | 4.60 | | |
| Outstanding at June 30, 2010 | 493,405 | $ 8.60 | 2.41 years | $ |
| Exercisable at June 30, 2010 | 255,699 | $ 12.11 | 1.82 years | $ |

Share-based compensation expense was not significant for the three month and six month periods ended June 30, 2010.

**6. Fair Value Election and Measurement**

Effective January 1, 2008, the Company adopted the provisions of SFAS No. 157, Fair Value Measurements , now codified in FASB ASC 820-10-35, for financial assets and financial liabilities. SFAS No. 157 establishes a common definition of fair value and framework for measuring fair value under U.S. GAAP. Fair value is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. FASB ASC 820-10-35 establishes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (level 1 measurements) and the lowest priority to unobservable inputs (level 3 measurements). The three levels of the fair value hierarchy under FASB ASC 820-10-35 are described below:

Level 1 Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities;

Level 2 Quoted prices in markets that are not active, or inputs that are observable, either directly, for substantially the full term of the asset or liability;

Level 3 Prices or valuation techniques that require inputs that are both significant to the fair value measurement and unobservable (i.e., supported by little or no market activity).

A financial instrument s level within the hierarchy is based on the lowest level of input that is significant to the fair value measurement.

In certain circumstances, fair value enables a company to more accurately align its financial performance with the economic value of hedged assets. Fair value enables a company to mitigate the non-economic earnings volatility caused from financial assets and financial liabilities being carried at different bases of accounting, as well as to more accurately portray the active and dynamic management of a company s balance sheet.

In accordance with SFAS No. 159 The Fair Value Option for Financial Assets and Financial Liabilities which is now codified in ASC 825-10-25, the Company has elected to record newly originated mortgage loans held-for-sale at fair value. The following is a description of mortgage loans held-for-sale as of June 30, 2010, for which fair value has been elected, including the specific reasons for electing fair value and the strategies for managing these assets on a fair value basis.

**Loans Held-for-Sale**

The Company records mortgage loans held-for-sale at fair value. The Company chose to record these mortgage loans held-for-sale at fair value in order to eliminate the complexities and inherent difficulties of achieving hedge accounting and to better align reported results with the underlying economic changes in value of the loans and related hedge instruments. This election impacts the timing and recognition of origination fees and costs, as well as servicing value. Specifically, origination fees and costs, which had been appropriately deferred under SFAS No. 91 Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases now codified in ASC 310-20-25 and previously recognized as part of the gain/loss on sale of the loans, are now recognized in earnings at the time of origination. Interest income on mortgage loans held-for-sale is recorded on an accrual basis in the consolidated statement of operations under the heading Interest income loans, including fees . The servicing value is included in the fair value of the Interest Rate Lock Commitments ( IRLCs ) with borrowers. The mark to market adjustments related to loans held-for-sale and the associated economic hedges are captured in mortgage banking activities.

**Valuation Methodologies and Fair Value Hierarchy**

The primary financial instruments that the Company carries at fair value include investment securities, IRLCs, derivative instruments, and loans held-for-sale. Classification in the fair value hierarchy of financial instruments is based on the criteria set forth in SFAS No. 157, now codified in FASB ASC 820-10-35.

Debt securities issued by U.S. Government corporations and agencies, debt securities issued by states and political subdivisions, and agency residential mortgage backed securities classified as available-for-sale are reported at fair value utilizing Level 2 inputs. For these securities, the Company obtains fair value measurements from an independent pricing service. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the bond s terms and conditions, among other things. The investments in the Company s portfolio are generally not quoted on an exchange but are actively traded in the secondary institutional markets.

The fair value of mortgage loans held-for-sale is based on what secondary markets are currently offering for portfolios with similar characteristics. The fair value measurements consider observable data that may include market trade pricing from brokers and the mortgage-backed security markets. As such, the Company classifies these loans as Level 2.

The Company classifies IRLCs on residential mortgage loans held-for-sale, which are derivatives under SFAS No. 133 now codified in ASC 815-10-15, on a gross basis within other liabilities or other assets. The fair value of these commitments, while based on interest rates observable in the market, is highly dependent on the ultimate closing of the loans. These pull-through rates are based on both the Company s historical data and the current interest rate environment and reflect the Company s best estimate of the likelihood that a commitment will ultimately result in a closed loan. As a result of the adoption of Staff Accounting Bulletin No. 109 ( SAB No. 109 ), the loan servicing value is also included in the fair value of IRLCs. Because these inputs are not transparent in market trades, IRLCs are considered to be Level 3 assets.

Derivative instruments are primarily transacted in the secondary mortgage and institutional dealer markets and priced with observable market assumptions at a mid-market valuation point, with appropriate valuation adjustments for liquidity and credit risk. For purposes of valuation adjustments to its derivative positions under FASB ASC 820-10-35, the Company has evaluated liquidity premiums that may be demanded by market participants, as well as the credit risk of its counterparties and its own credit if applicable. To date, no material losses due to a counterparty s inability to pay any net uncollateralized position has been incurred.

The credit risk associated with the underlying cash flows of an instrument carried at fair value was a consideration in estimating the fair value of certain financial instruments. Credit risk was considered in the valuation through a variety of inputs, as applicable, including, the actual default and loss severity of the collateral, and level of subordination. The assumptions used to estimate credit risk applied relevant information that a market participant would likely use in valuing an instrument. Because mortgage loans held-for-sale are sold within a few weeks of origination, it is unlikely to demonstrate any of the credit weaknesses discussed above and as a result, there were no credit related adjustments to fair value at June 30, 2010.

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The following tables present financial assets measured at fair value at June 30, 2010, and December 31, 2009 on a recurring basis and the change in fair value for those specific financial instruments in which fair value has been elected at June 30, 2010 and 2009. The changes in the fair value of economic hedges were also recorded in mortgage banking activities and are designed to partially offset the change in fair value of the financial instruments referenced in the tables below.

| | | Fair Value Measurements at June 30, 2010 | | |
|---|---|---|---|---|
| | Assets Measured at Fair Value June 30, 2010 | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| | | (In Thousands) | | |
| Debt securities issued by U.S. Government corporations and agencies | $ 77,739 | $ | $ 77,739 | $ |
| Debt securities issued by states and political subdivisions | 11,463 | | 11,463 | |
| Residential mortgage-backed securities Agency | 74,880 | | 74,880 | |
| Mortgage loans held-for-sale | 134,962 | | 134,962 | |
| Other Assets(1) | 2,447 | | | 2,447 |
| Other Liabilities(1) | 2,714 | | | 2,714 |

(1) This amount includes mortgage related interest rate lock commitments and derivative financial instruments to hedge interest rate risk. Interest rate lock commitments were recorded on a gross basis.

| | | Fair Value Measurements at December 31, 2009 | | |
|---|---|---|---|---|
| | Assets | | Significant | |

| | Measured at Fair Value December 31, 2009 | Quoted Prices in Active Markets for Identical Assets (Level 1) | Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|---|---|---|---|---|
| | | *(In Thousands)* | | |
| Debt securities issued by U.S. Government corporations and agencies | $ 63,119 | $ | $ 63,119 | $ |
| Debt securities issued by states and political subdivisions | 11,407 | | 11,407 | |
| Residential mortgage-backed securities Agency | 62,391 | | 62,391 | |
| Mortgage loans held-for-sale | 80,869 | | 80,869 | |
| Other Assets[1] | 1,778 | | | 1,778 |
| Other Liabilities[1] | 55 | | | 55 |

(1) This amount includes mortgage related interest rate lock commitments and derivative financial instruments to hedge interest rate risk. Interest rate lock commitments were recorded on a gross basis.

| | For Items Measured at Fair Value Pursuant to Election of the Fair Value Option: Fair Value Gain (Loss) related to Mortgage Banking Activities for the Three Months Ended | |
|---|---|---|
| | June 30, 2010 | June 30, 2009 |
| | *(In Thousands)* | |
| Mortgage loans held-for-sale | $ 3,270 | $ (1,766) |

| | For Items Measured at Fair Value Pursuant to Election of the Fair Value Option: Fair Value Gain (Loss) related to Mortgage Banking Activities for the Six Months Ended | |
|---|---|---|
| | **June 30, 2010** | **June 30, 2009** |
| | *(In Thousands)* | |
| Mortgage loans held-for-sale | $ 3,627 | $ (913) |

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The table below presents a reconciliation of all assets and liabilities measured at fair value on a recurring basis using significant unobservable inputs (level 3) during the three and six months ended June 30, 2010 and 2009.

| | Other Assets(1) | Other Liabilities(1) |
|---|---|---|
| | *(In Thousands)* | |
| Beginning Balance April 1, 2010 | $ 1,288 | $ (37) |
| Total gains (losses) included in earnings:(2) | | |
| Issuances | 2,447 | (2,714) |
| Settlements and closed loans | (482) | 2 |
| Expirations | (806) | 35 |
| Total gains (losses) included in other comprehensive income | | |
| Ending Balance June 30, 2010 (3) | $ 2,447 | $ (2,714) |

(1) Includes mortgage related interest rate lock commitments and derivative financial instruments entered into to hedge interest rate risk.

(2) Amounts included in earnings are recorded in mortgage banking activities.

(3) Represents the amount included in earnings attributable to the changes in unrealized gains/losses relating to IRLCs and

derivatives still held at period end.

| | Other Assets[1] | Other Liabilities[1] |
|---|---|---|
| | *(In Thousands)* | |
| Beginning Balance January 1, 2010 | $ 1,778 | $ (55) |
| Total gains (losses) included in earnings:[2] | | |
| Issuances | 3,735 | (2,751) |
| Settlements and closed loans | (660) | 46 |
| Expirations | (2,406) | 46 |
| Total gains (losses) included in other comprehensive income | | |
| Ending Balance June 30, 2010[3] | $ 2,447 | $ (2,714) |

(1) Includes mortgage related interest rate lock commitments and derivative financial instruments entered into to hedge interest rate risk.

(2) Amounts included in earnings are recorded in mortgage banking activities.

(3) Represents the amount included in earnings attributable to the changes in unrealized gains/losses relating to IRLCs and derivatives still

held at period end.

| | | Other Assets[1] | | Other Liabilities[1] |
|---|---|---|---|---|
| | | *(In Thousands)* | | |
| Beginning Balance April 1, 2009 | $ | 1,268 | $ | (467) |
| Total gains (losses) included in earnings:[2] | | | | |
| Issuances | | 2,220 | | (33) |
| Settlements and closed loans | | (790) | | |
| Expirations | | (478) | | 467 |
| Total gains (losses) included in other comprehensive income | | | | |
| Ending Balance June 30, 2009[3] | $ | 2,220 | $ | (33) |

(1) Includes mortgage related interest rate lock commitments and derivative financial instruments entered into to hedge interest rate risk.

(2) Amounts included in earnings are recorded in mortgage banking activities.

(3) Represents the amount included in earnings attributable to the changes in unrealized gains/losses relating to IRLCs and derivatives still held at period

end.

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| | Other Assets[1] | Other Liabilities[1] |
|---|---|---|
| | *(In Thousands)* | |
| Beginning Balance January 1, 2009 | $ | $ |
| Total gains (losses) included in earnings:[2] | | |
| Issuances | 3,488 | (500) |
| Settlements and closed loans | (790) | |
| Expirations | (478) | 467 |
| Total gains (losses) included in other comprehensive income | | |
| Ending Balance June 30, 2009[3] | $ 2,220 | $ (33) |

(1) Includes mortgage related interest rate lock commitments and derivative financial instruments entered into to hedge interest rate risk.

(2) Amounts included in earnings are recorded in mortgage banking activities.

(3) Represents the amount included in earnings attributable to the changes in unrealized gains/losses relating to IRLCs and derivatives still held at period

end.

The following tables present the assets that are measured at fair value on a non-recurring basis by level within the fair value hierarchy as reported on the consolidated statements of financial position at June 30, 2010 and December 31, 2009.

| | | Fair Value Measurements at June 30, 2010 | | | |
|---|---|---|---|---|---|
| | Total | Quoted Prices in Active Markets for Identical Assets Level 1 | Significant Other Observable Inputs Level 2 | Significant Unobservable Inputs Level 3 | Valuation Allowance |
| | | | (In Thousands) | | |
| Impaired loans | $ 40,963 | $ | $ | $ 40,963 | $ (2,949) |
| ORE | 22,225 | | | 22,225 | (5,922) |
| Mortgage servicing rights | 1,206 | | | 1,206 | (134) |

| | | Fair Value Measurements at December 31, 2009 | | | |
|---|---|---|---|---|---|
| | Total | Quoted Prices in Active Markets for Identical Assets Level 1 | Significant Other Observable Inputs Level 2 | Significant Unobservable Inputs Level 3 | Valuation Allowance |
| | | | (In Thousands) | | |
| SBA loans held-for-sale | $ 4,807 | $ | $ | $ 4,807 | $ (87) |
| Impaired loans | 75,971 | | | 75,971 | (6,038) |
| ORE | 21,780 | | | 21,780 | (3,975) |
| Mortgage servicing rights | 875 | | | 875 | (83) |

SBA loans held-for-sale are measured at the lower of cost or fair value. Fair value is based on recent trades for similar loan pools as well as offering prices for similar assets provided by buyers in the SBA secondary market. If the cost of a loan is determined to be greater than the fair value of similar loans, the impairment is recorded by the establishment of a reserve to reduce the value of the loan. There were no impaired SBA loans held-for-sale at June 30, 2010.

Impaired loans are evaluated and valued at the time the loan is identified as impaired, at the lower of cost or fair value. Fair value is measured based on the value of the collateral securing these loans and is classified as a Level 3 in the fair value hierarchy. Collateral may include real estate or business assets, including equipment, inventory and accounts receivable. The value of real estate collateral is determined based on an appraisal by qualified licensed appraisers hired by the Company. If significant, the value of business equipment is based on an appraisal by qualified licensed appraisers hired by the Company otherwise, the equipment s net book value on the business financial statements is the basis for the value of business equipment. Inventory and accounts receivable collateral are valued based on independent field examiner review or aging reports. Appraised and reported values may be discounted based on management s historical knowledge, changes in market conditions from the time of the valuation, and management s expertise and knowledge of the client and client s business. Impaired loans are evaluated on at least a quarterly basis for additional impairment and adjusted accordingly.

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Mortgage servicing rights are initially recorded at fair value when mortgage loans are sold service retained. These assets are then amortized in proportion to and over the period of estimated net servicing income. On a monthly basis these servicing assets are assessed for impairment based on fair value. Management determines fair value by stratifying the servicing portfolio into homogeneous subsets with unique behavior characteristics, converting those characteristics into income and expense streams, adjusting those streams for prepayments, present valuing the adjusted streams, and combining the present values into a total. If the cost basis of any loan stratification tranche is higher than the present value of the tranche, an impairment is recorded.

Foreclosed assets in Other Real Estate are adjusted to fair value upon transfer of the loans to foreclosed assets. Subsequently, foreclosed assets are carried at the lower of carrying value or fair value less estimated selling costs. Fair value is based upon independent market prices, appraised values of the collateral or management s estimation of the value of the collateral. When the fair value of the collateral is based on an observable market price or a current appraised value, the Company records the foreclosed asset as nonrecurring Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Company records the foreclosed asset as nonrecurring Level 3. Appraised and reported values may be discounted based on management s historical knowledge, changes in market conditions from the time of the valuation, and management s expertise and knowledge of the client and client s business.

The following tables present the difference between the aggregate fair value and the aggregate unpaid principal balance of loans held-for-sale for which the fair value option has been elected as of June 30, 2010 and December 31, 2009. The tables also include the difference between aggregate fair value and the aggregate unpaid principal balance of loans that are 90 days or more past due, as well as loans in nonaccrual status.

| | Aggregate Fair Value June 30, 2010 | Aggregate Unpaid Principal Balance Under FVO June 30, 2010 | Fair Value Over Unpaid Principal |
|---|---|---|---|
| | | *(In Thousands)* | |
| Loans held-for-sale | $ 134,962 | $ 131,094 | $ 3,868 |
| Past due loans of 90+ days | | | |
| Nonaccrual loans | | | |

| | Aggregate Fair Value December 31, 2009 | Aggregate Unpaid Principal Balance Under FVO December 31, 2009 | Fair Value Over/(Under) Unpaid Principal |
|---|---|---|---|
| | | *(In Thousands)* | |
| Loans held-for-sale | $ 80,869 | $ 80,629 | $ 240 |
| Past due loans of 90+ days | | | |
| Nonaccrual loans | | | |

SFAS No. 107, Disclosures about Fair Value of Financial Instruments, ( SFAS No. 107 ) as amended by FASB Staff Position No. FAS 107-1 and APB 28-1, Interim Disclosures about Fair Value of Financial Instruments now codified in ASC 825-10-50 requires disclosure of fair value information about financial instruments, whether or not recognized in the balance sheet, for which it is practicable to estimate that value. In cases where quoted market prices are not available, fair values are based on settlements using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. In that regard, the derived fair value estimates cannot be substantiated by comparison to independent markets, and, in many cases, could not be realized in immediate settlement of the instrument. ASC 825-10-50 excludes certain financial instruments and all non-financial instruments from its disclosure requirements. Accordingly, the aggregate fair value amounts presented do not represent the underlying value of the Company.

| | **June 30, 2010** | | **December 31, 2009** | |
|---|---|---|---|---|
| | **Carrying Amount** | **Fair Value** | **Carrying Amount** | **Fair Value** |
| | *(In Thousands)* | | | |
| **Financial Instruments (Assets):** | | | | |
| Cash and due from banks | $ 110,658 | $ 110,658 | $ 170,692 | $ 170,692 |
| Federal funds sold | 519 | 519 | 428 | 428 |
| Investment securities available-for-sale | 164,082 | 164,082 | 136,917 | 136,917 |
| Investment securities held-to-maturity | 16,896 | 18,053 | 19,326 | 19,942 |
| Investment in FHLB stock | 6,857 | 6,857 | 6,767 | 6,767 |
| Total loans | 1,465,559 | 1,350,742 | 1,391,018 | 1,283,330 |
| Total financial instruments (assets) | 1,764,571 | $ 1,650,911 | 1,725,148 | $ 1,618,076 |
| Non-financial instruments (assets) | 120,030 | | 126,372 | |
| Total assets | $ 1,884,601 | | $ 1,851,520 | |
| **Financial Instruments (Liabilities):** | | | | |
| Noninterest-bearing demand deposits | $ 172,919 | $ 172,919 | $ 157,511 | $ 157,511 |
| Interest-bearing deposits | 1,390,702 | 1,398,584 | 1,393,214 | 1,402,637 |
| Total deposits | 1,563,621 | 1,571,503 | 1,550,725 | 1,560,148 |
| Short-term borrowings | 49,902 | 49,591 | 41,870 | 41,143 |
| Subordinated debt | 67,527 | 61,813 | 67,527 | 60,573 |
| Other long-term debt | 50,000 | 50,932 | 50,000 | 51,017 |
| Total financial instruments (liabilities) | 1,731,050 | $ 1,733,839 | 1,710,122 | $ 1,712,881 |
| Non-financial instruments (liabilities and shareholders equity) | 153,551 | | 141,398 | |
| Total liabilities and shareholders equity | $ 1,884,601 | | $ 1,851,520 | |

The carrying amounts reported in the consolidated balance sheets for cash, due from banks, and Federal funds sold approximate the fair values of those assets. For investment securities, fair value equals quoted market prices, if available. If a quoted market price is not available, fair value is estimated using quoted market prices for similar securities or dealer quotes.

Fair values are estimated for portfolios of loans with similar financial characteristics. Loans are segregated by type. The fair value of performing loans is calculated by discounting scheduled cash flows through the remaining maturities using estimated market discount rates that reflect the credit and interest rate risk inherent in the loans along with a market risk premium and liquidity discount.

Fair value for significant nonperforming loans is estimated taking into consideration recent external appraisals of the underlying collateral for loans that are collateral dependent. If appraisals are not available or if the loan is not collateral dependent, estimated cash flows are discounted using a rate commensurate with the risk associated with the estimated cash flows. Assumptions regarding credit risk, cash flows, and discount rates are judgmentally determined using available market information and specific borrower information.

The fair value of deposits with no stated maturities, such as noninterest-bearing demand deposits, savings, interest-bearing demand, and money market accounts, is equal to the amount payable on demand. The fair value of time deposits is based on the discounted value of contractual cash flows based on the discounted rates currently offered for deposits of similar remaining maturities.

The carrying amounts reported in the consolidated balance sheets for short-term debt generally approximate those liabilities fair values with the exception of FHLB advances which are estimated based on the current rates offered to us for debt of the same remaining maturity.

The fair value of the Company s long-term debt is estimated based on the quoted market prices for the same or similar issues or on the current rates offered to us for debt of the same remaining maturities.

For off-balance sheet instruments, fair values are based on rates currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counterparties credit standing for loan commitments and letters of credit. Fees related to these instruments were immaterial at June 30, 2010, and December 31, 2009, and the carrying amounts represent a reasonable approximation of their fair values. Loan commitments, letters and lines of credit, and similar obligations typically have variable interest rates and clauses that deny funding if the customer s credit quality deteriorates. Therefore, the fair values of these items are not significant and are not included in the foregoing schedule.

This presentation excludes certain nonfinancial instruments. The disclosures also do not include certain intangible assets, such as customer relationships, and deposit base intangibles. Accordingly, the aggregate fair value amounts presented do not represent the underlying value of the Company.

**7. Other Real Estate**

Other real estate ( ORE ) consisted of the following:

| | June 30, 2010 | December 31, 2009 |
|---|---|---|
| | *(In Thousands)* | |
| Commercial | $ 3,916 | $ 3,367 |
| Residential homes | 7,809 | 7,040 |
| Residential lots | 16,422 | 15,348 |
| Gross other real estate | 28,147 | 25,755 |
| Valuation allowance | (5,922) | (3,975) |
| Other real estate, net | $ 22,225 | $ 21,780 |

Capitalized costs represent disbursements made to complete construction or development of foreclosed property and are added to the cost of the ORE recorded on the Consolidated Balance Sheets to the extent realizable. Net gains (losses) on sales are included in Other Income in the Consolidated Statements of Operations. Expensed costs are disbursements made for the taxes, maintenance or repair of properties held in ORE. Capitalized costs, net gains (losses) on sales, provision for ORE losses, and expensed costs related to ORE are summarized below:

| | For the Six Months Ended June 30, | |
|---|---|---|
| | 2010 | 2009 |
| | *(In Thousands)* | |