

FLUSHING FINANCIAL CORP  
Form 10-Q  
August 09, 2012

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

FORM 10-Q

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

For the quarterly period ended June 30, 2012

Commission file number 001-33013

FLUSHING FINANCIAL CORPORATION  
(Exact name of registrant as specified in its charter)

Delaware  
(State or other jurisdiction of incorporation or organization)

11-3209278  
(I.R.S. Employer Identification No.)

1979 Marcus Avenue, Suite E140, Lake Success, New York 11042  
(Address of principal executive offices)

(718) 961-5400  
(Registrant's telephone number, including area code)

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

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 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                       Smaller reporting company

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

The number of shares of the registrant's Common Stock outstanding as of July 31, 2012 was 30,951,445.

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## PART I – FINANCIAL INFORMATION

FLUSHING FINANCIAL CORPORATION and SUBSIDIARIES  
Consolidated Statements of Financial Condition  
(Unaudited)

## Item 1. Financial Statements

(Dollars in thousands, except per share data)	June 30, 2012	December 31, 2011
<b>ASSETS</b>		
Cash and due from banks	\$41,216	\$ 55,721
Securities available for sale:		
Mortgage-backed securities (\$30,968 and \$37,787 at fair value pursuant to the fair value option at June 30, 2012 and December 31, 2011, respectively)	738,099	747,288
Other securities (\$31,377 and \$30,942 at fair value pursuant to the fair value option at June 30, 2012 and December 31, 2011 respectively)	221,918	65,242
Loans available for sale	740	-
Loans:		
Multi-family residential	1,453,049	1,391,221
Commercial real estate	552,513	580,783
One-to-four family mixed-use property	669,913	693,932
One-to-four family residential	208,273	220,431
Co-operative apartments	6,834	5,505
Construction	39,511	47,140
Small Business Administration	11,233	14,039
Taxi medallion	37,291	54,328
Commercial business and other	242,967	206,614
Net unamortized premiums and unearned loan fees	13,911	14,888
Allowance for loan losses	(30,899 )	(30,344 )
Net loans	3,204,596	3,198,537
Interest and dividends receivable	18,706	17,965
Bank premises and equipment, net	23,506	24,417
Federal Home Loan Bank of New York stock	36,847	30,245
Bank owned life insurance	84,839	83,454
Goodwill	16,127	16,127
Core deposit intangible	703	937
Other assets	48,532	48,016
<b>Total assets</b>	<b>\$4,435,829</b>	<b>\$ 4,287,949</b>
<b>LIABILITIES</b>		
Due to depositors:		
Non-interest bearing	\$139,510	\$ 118,507
Interest-bearing:		
Certificate of deposit accounts	1,500,483	1,529,110
Savings accounts	322,728	349,630
Money market accounts	166,877	200,183
NOW accounts	971,128	919,029
Total interest-bearing deposits	2,961,216	2,997,952
Mortgagors' escrow deposits	35,880	29,786
	641,708	499,839

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Borrowed funds (\$24,356 and \$26,311 at fair value pursuant to the fair value option at June 30, 2012 and December 31, 2011, respectively)

Securities sold under agreements to repurchase	185,300	185,300
Other liabilities	41,249	39,654
Total liabilities	4,004,863	3,871,038

STOCKHOLDERS' EQUITY

Preferred stock (\$0.01 par value; 5,000,000 shares authorized; None issued)	-	-
Common stock (\$0.01 par value; 100,000,000 shares authorized; 31,530,595 shares issued at June 30, 2012 and December 31, 2011; 30,949,332 shares and 30,904,177 shares outstanding at June 30, 2012 and December 31, 2011, respectively)	315	315
Additional paid-in capital	197,709	195,628
Treasury stock, at average cost (581,263 shares and 626,418 shares at June 30, 2012 and December 31, 2011, respectively)	(7,086 )	(7,355 )
Retained earnings	231,224	223,510
Accumulated other comprehensive income, net of taxes	8,804	4,813
Total stockholders' equity	430,966	416,911
Total liabilities and stockholders' equity	\$4,435,829	\$ 4,287,949

The accompanying notes are an integral part of these consolidated financial statements

## PART I – FINANCIAL INFORMATION

FLUSHING FINANCIAL CORPORATION and SUBSIDIARIES  
Consolidated Statements of Income  
(Unaudited)

(Dollars in thousands, except per share data)	For the three months ended June 30,		For the six months ended June 30 ,	
	2012	2011	2012	2011
<b>Interest and dividend income</b>				
Interest and fees on loans	\$46,123	\$48,121	\$92,683	\$96,811
<b>Interest and dividends on securities:</b>				
Interest	8,045	8,149	15,676	16,256
Dividends	205	202	412	404
Other interest income	11	27	28	54
Total interest and dividend income	54,384	56,499	108,799	113,525
<b>Interest expense</b>				
Deposits	10,225	12,354	21,135	24,688
Other interest expense	5,872	7,350	12,032	14,887
Total interest expense	16,097	19,704	33,167	39,575
Net interest income	38,287	36,795	75,632	73,950
Provision for loan losses	5,000	5,000	11,000	10,000
Net interest income after provision for loan losses	33,287	31,795	64,632	63,950
<b>Non-interest income (loss)</b>				
Other-than-temporary impairment ("OTTI") charge	(6,218 )	-	(6,218 )	(3,939 )
Less: Non-credit portion of OTTI charge recorded in Other Comprehensive Income, before taxes	5,442	-	5,442	3,013
Net OTTI charge recognized in earnings	(776 )	-	(776 )	(926 )
Loan fee income	634	515	1,100	949
Banking services fee income	409	388	864	849
Net gain on sale of loans	39	-	39	-
Net gain from sale of securities	-	-	-	-
Net loss from fair value adjustments	(562 )	(165 )	(1,010 )	(820 )
Federal Home Loan Bank of New York stock dividends	338	342	723	842
Bank owned life insurance	689	695	1,385	1,362
Other income	337	360	661	750
Total non-interest income	1,108	2,135	2,986	3,006
<b>Non-interest expense</b>				
Salaries and employee benefits	10,457	9,682	21,498	19,709
Occupancy and equipment	1,918	1,874	3,848	3,741
Professional services	1,553	1,637	3,275	3,236
FDIC deposit insurance	1,087	951	2,104	2,379
Data processing	1,051	1,181	2,027	2,186
Depreciation and amortization	785	779	1,619	1,545
Other real estate owned/foreclosure expense	595	531	1,307	868

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Other operating expenses	2,793	2,230	6,097	5,216
Total non-interest expense	20,239	18,865	41,775	38,880
Income before income taxes	14,156	15,065	25,843	28,076
Provision for income taxes				
Federal	4,236	4,564	7,860	8,476
State and local	1,283	1,427	2,217	2,573
Total taxes	5,519	5,991	10,077	11,049
Net income	\$8,637	\$9,074	\$15,766	\$17,027
Basic earnings per common share	\$0.28	\$0.29	\$0.52	\$0.55
Diluted earnings per common share	\$0.28	\$0.29	\$0.52	\$0.55
Dividends per common share	\$0.13	\$0.13	\$0.26	\$0.26

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

## PART I – FINANCIAL INFORMATION

FLUSHING FINANCIAL CORPORATION and SUBSIDIARIES  
 Consolidated Statements of Comprehensive Income  
 (Unaudited)

(Dollars in thousands)	For the three months ended June 30,		For the six months ended June 30,	
	2012	2011	2012	2011
<b>Comprehensive Income</b>				
Net income	\$ 8,637	\$ 9,074	\$ 15,766	\$ 17,027
Amortization of actuarial losses	149	79	298	156
Amortization of prior service credits	(7 )	(7 )	(13 )	(13 )
OTTI charges included in income	437	-	437	518
Unrealized gains (losses) on securities, net	2,052	3,933	3,269	443
Comprehensive income	\$ 11,268	\$ 13,079	\$ 19,757	\$ 18,131

The accompanying notes are an integral part of these consolidated financial statements



## PART I – FINANCIAL INFORMATION

FLUSHING FINANCIAL CORPORATION and SUBSIDIARIES  
Consolidated Statements of Cash Flows  
(Unaudited)

	For the six months ended June 30,	
(Dollars in thousands)	2012	2011
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net income	\$ 15,766	\$ 17,027
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	11,000	10,000
Depreciation and amortization of bank premises and equipment	1,619	1,545
Net gain on sale of loans	(39 )	-
Amortization of premium, net of accretion of discount	3,210	2,795
Net loss from fair value adjustments	1,010	820
OTTI charge recognized in earnings	776	926
Income from bank owned life insurance	(1,385 )	(1,362 )
Stock-based compensation expense	2,219	1,663
Deferred compensation	(304 )	244
Amortization of core deposit intangibles	234	234
Excess tax benefit from stock-based payment arrangements	(78 )	(205 )
Deferred income tax provision	(485 )	(568 )
Decrease in prepaid FDIC assessment	1,953	2,179
Increase (decrease) in other liabilities	4,136	(844 )
Increase in other assets	(3,833 )	(7,544 )
Net cash provided by operating activities	35,799	26,910
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Purchases of bank premises and equipment	(708 )	(1,275 )
Net purchase of Federal Home Loan Bank of New York shares	(6,602 )	(2,421 )
Purchases of securities available for sale	(225,430 )	(119,462 )
Proceeds from maturities and prepayments of securities available for sale	82,286	68,362
Net (originations) and repayments of loans	(37,967 )	38,146
Purchases of loans	(3,456 )	(14,455 )
Proceeds from sale of real estate owned	1,229	515
Proceeds from sale of delinquent loans	16,494	7,766
Net cash used in investing activities	(174,154 )	(22,824 )
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Net increase in non-interest bearing deposits	21,003	12,914
Net decrease in interest-bearing deposits	(37,243 )	(87,728 )
Net increase in mortgagors' escrow deposits	6,094	5,328
Net proceeds from short-term borrowed funds	60,740	104,639
Proceeds from long-term borrowings	162,518	26,335
Repayment of long-term borrowings	(80,000 )	(75,416 )
Purchases of treasury stock	(2,223 )	(374 )
Excess tax benefit from stock-based payment arrangements	78	205
Proceeds from issuance of common stock upon exercise of stock options	814	2,016

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Cash dividends paid	(7,931 )	(8,010 )
Net cash provided by (used in) financing activities	123,850	(20,091 )
Net decrease in cash and cash equivalents	(14,505 )	(16,005 )
Cash and cash equivalents, beginning of period	55,721	47,789
Cash and cash equivalents, end of period	\$ 41,216	\$ 31,784

SUPPLEMENTAL CASH FLOW DISCLOSURE

Interest paid	\$ 32,879	\$ 39,210
Income taxes paid	11,573	13,656
Taxes paid if excess tax benefits were not tax deductible	11,651	13,861
Non-cash activities:		
Loans transferred to real estate owned	1,632	1,861
Loans provided for the sale of real estate owned	1,428	1,345
Loans held for investment transferred to available for sale	740	-

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

PART I – FINANCIAL INFORMATION

FLUSHING FINANCIAL CORPORATION and SUBSIDIARIES  
 Consolidated Statements of Changes in Stockholders' Equity  
 (Unaudited)

(Dollars in thousands, except per share data)

Common Stock

Balance, beginning of period

Issuance upon exercise of stock options (155,061 common shares for the six months ended June 30, 2011)

Shares issued upon vesting of restricted stock unit awards (119,600 common shares for the six months ended June 30, 2011)

Balance, end of period

Additional Paid-In Capital

Balance, beginning of period

Award of common shares released from Employee Benefit Trust (150,564 and 135,617 common shares for the six months ended June 30, 2012 and 2011)

Shares issued upon vesting of restricted stock unit awards (113,072 and 119,600 common shares for the six months ended June 30, 2012 and 2011)

Issuance upon exercise of stock options (102,540 and 175,570 common shares for the six months ended June 30, 2012 and 2011)

Stock-based compensation activity, net

Stock-based income tax benefit

Balance, end of period

Treasury Stock

Balance, beginning of period

Purchases of shares outstanding (130,900 common shares for the six months ended June 30, 2012)

Shares issued upon vesting of restricted stock unit awards (142,022 common shares for the six months ended June 30, 2012)

Issuance upon exercise of stock options (113,020 and 20,509 common shares for the six months ended June 30, 2012 and 2011)

Purchases of shares to fund options exercised (40,866 and 3,794 common shares for the six months ended June 30, 2012 and 2011)

Repurchase of shares to satisfy tax obligations (38,121 and 27,368 common shares for the six months ended June 30, 2012 and 2011)

Balance, end of period

Retained Earnings

Balance, beginning of period

Net income

Cash dividends declared and paid on common shares (\$0.26 per common share for the six months ended June 30, 2012 and 2011)

Issuance upon exercise of stock options (10,480 and 175,570 common shares for the six months ended June 30, 2012 and 2011)

Shares issued upon vesting of restricted stock unit awards (28,950 common shares for the six months ended June 30, 2012)

Balance, end of period

Accumulated Other Comprehensive Income (Loss)

Balance, beginning of period

Change in net unrealized gains (losses) on securities available for sale, net of taxes of approximately (\$2,566) and (\$336) for the six months ended June 30, 2012 and 2011, respectively

Amortization of actuarial losses, net of taxes of approximately (\$233) and (\$122) for the six months ended June 30, 2012 and 2011

Amortization of prior service credits, net of taxes of approximately \$10 for both six month periods ended June 30, 2012 and 2011

OTTI charges included in income, net of taxes of approximately (\$339) and (\$408) for the six months ended June 30, 2012 and 2011

Balance, end of period

Total Stockholders' Equity

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

PART I – FINANCIAL INFORMATION  
FLUSHING FINANCIAL CORPORATION and SUBSIDIARIES  
Notes to Consolidated Financial Statements  
(Unaudited)

1. Basis of Presentation

The primary business of Flushing Financial Corporation (the “Holding Company”) is the operation of its wholly-owned subsidiary, Flushing Savings Bank, FSB (the “Savings Bank”). The Holding Company and its direct and indirect wholly-owned subsidiaries, the Savings Bank, Flushing Commercial Bank, Flushing Preferred Funding Corporation, Flushing Service Corporation, and FSB Properties Inc., are collectively herein referred to as the “Company.” The unaudited consolidated financial statements presented in this Quarterly Report on Form 10-Q (“Quarterly Report”) include the collective results of the Company on a consolidated basis.

The Holding Company also owns Flushing Financial Capital Trust II, Flushing Financial Capital Trust III, and Flushing Financial Capital Trust IV (the “Trusts”), which are special purpose business trusts. The Trusts are not included in the Company’s consolidated financial statements as the Company would not absorb the losses of the Trusts if losses were to occur.

The accompanying unaudited consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”) and general practices within the banking industry. The information furnished in these interim statements reflects all adjustments which are, in the opinion of management, necessary for a fair statement of the results for such presented periods of the Company. Such adjustments are of a normal recurring nature, unless otherwise disclosed in this Quarterly Report. All inter-company balances and transactions have been eliminated in consolidation. The results of operations in the interim statements are not necessarily indicative of the results that may be expected for the full year.

The accompanying unaudited consolidated financial statements have been prepared in conformity with the instructions to Quarterly Report on Form 10-Q and Article 10, Rule 10-01 of Regulation S-X for interim financial statements. Accordingly, certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission (“SEC”). The unaudited consolidated interim financial information should be read in conjunction with the Company’s Annual Report on Form 10-K for the year ended December 31, 2011.

When necessary, certain reclassifications have been made to the prior-period consolidated financial statements to conform to the current-period presentation.

2. Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, and disclosure of contingent assets and liabilities at the date of the financial statements, and reported amounts of revenue and expenses during the reporting period. Estimates that are particularly susceptible to change in the near term are used in connection with the determination of the allowance for loan losses, the evaluation of goodwill for impairment, the evaluation of the need for a valuation allowance of the Company’s deferred tax assets and the evaluation of other-than-temporary impairment (“OTTI”) on securities. The current economic environment has increased the degree of uncertainty inherent in these material estimates. Actual results could differ from these estimates.

3. Earnings Per Share

Earnings per share is computed in accordance with Accounting Standards Codification (“ASC”) Topic 260 “Earnings Per Share,” which provides that unvested share-based payment awards that contain nonforfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and as such should be included in the calculation of earnings per share. Basic earnings per common share is computed by dividing net income available to common shareholders by the total weighted average number of common shares outstanding, which includes unvested participating securities. The Company’s unvested restricted stock and restricted stock unit awards are considered participating securities. Therefore, weighted average common shares outstanding used for computing basic earnings per common share includes common shares outstanding plus unvested restricted stock and restricted stock unit awards. The computation of diluted earnings per share includes the additional dilutive effect of stock options outstanding during the period. Common stock equivalents that are anti-dilutive are not included in the computation of diluted earnings per common share. The numerator for calculating basic and diluted earnings per common share is net income available to common shareholders.

PART I – FINANCIAL INFORMATION  
 FLUSHING FINANCIAL CORPORATION and SUBSIDIARIES  
 Notes to Consolidated Financial Statements  
 (Unaudited)

Earnings per common share has been computed based on the following:

	For the three months ended June 30,		For the six months ended June 30,	
	2012	2011	2012	2011
	(In thousands, except per share data)			
Net income, as reported	\$8,637	\$9,074	\$ 15,766	\$ 17,027
Divided by:				
Weighted average common shares outstanding	30,472	30,823	30,434	30,722
Weighted average common stock equivalents	20	41	22	54
Total weighted average common shares outstanding and common stock equivalents	30,492	30,864	30,456	30,776
Basic earnings per common share	\$0.28	\$0.29	\$ 0.52	\$ 0.55
Diluted earnings per common share (1)	\$0.28	\$0.29	\$ 0.52	\$ 0.55
Dividend payout ratio	46.4	% 44.8	% 50.0	% 47.3

(1) For the three and six months ended June 30, 2012, options to purchase 720,865 shares at an average exercise price of \$16.71 were not included in the computation of diluted earnings per common share as they are anti-dilutive. For the three and six months ended June 30, 2011, options to purchase 560,550 shares at an average exercise price of \$17.62 were not included in the computation of diluted earnings per common share as they are anti-dilutive.

#### 4. Debt and Equity Securities

The Company's investments are classified in one of the following three categories and accounted for accordingly: (1) trading securities, (2) securities available for sale and (3) securities held-to-maturity.

The Company did not hold any trading securities or securities held-to-maturity during the three and six month periods ended June 30, 2012 and 2011. Securities available for sale are recorded at fair value.

The following table summarizes the Company's portfolio of securities available for sale at June 30, 2012:

	Amortized	Fair Value	Gross	Gross
	Cost		Unrealized	Unrealized
			Gains	Losses
	(In thousands)			
U.S. government agencies	\$31,739	\$ 31,956	\$ 217	\$ -
Corporate	85,418	86,400	1,312	330
Municipals	65,431	64,927	300	804
Mutual funds	21,675	21,675	-	-
Other	22,198	16,960	18	5,256
Total other securities	226,461	221,918	1,847	6,390
REMIC and CMO	462,193	480,743	25,654	7,104
GNMA	53,828	58,418	4,590	-

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FNMA	161,782	169,853	8,071	-
FHLMC	28,342	29,085	743	-
Total mortgage-backed securities	706,145	738,099	39,058	7,104
Total securities available for sale	\$932,606	\$ 960,017	\$ 40,905	\$ 13,494

Mortgage-backed securities shown in the table above include two private issue collateralized mortgage obligations (“CMOs”) that are collateralized by commercial real estate mortgages with amortized cost and market values totaling \$16.5 million and \$16.9 million, respectively, at June 30, 2012. The remaining private issue mortgage-backed securities are backed by one-to-four family residential mortgage loans.

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PART I – FINANCIAL INFORMATION  
 FLUSHING FINANCIAL CORPORATION and SUBSIDIARIES  
 Notes to Consolidated Financial Statements  
 (Unaudited)

The following table shows the Company’s available for sale securities with gross unrealized losses and their fair value aggregated by category and length of time the individual securities have been in a continuous unrealized loss position, at June 30, 2012:

	Total Unrealized		Less than 12 months Unrealized		12 months or more Unrealized	
	Fair Value	Losses	Fair Value	Losses	Fair Value	Losses
	(In thousands)					
Corporate	\$39,140	\$ 330	\$39,140	\$ 330	\$-	\$ -
Municipals	42,326	804	42,326	804	-	-
Other	4,307	5,256	-	-	4,307	5,256
Total other securities	85,773	6,390	81,466	1,134	4,307	5,256
REMIC and CMO	38,234	7,104	12,609	150	25,625	6,954
Total mortgage-backed securities	38,234	7,104	12,609	150	25,625	6,954
Total securities available for sale	\$124,007	\$ 13,494	\$ 94,075	\$ 1,284	\$ 29,932	\$ 12,210

OTTI losses on impaired securities must be fully recognized in earnings if an investor has the intent to sell the debt security or if it is more likely than not that the investor will be required to sell the debt security before recovery of its amortized cost. However, even if an investor does not expect to sell a debt security, the investor must evaluate the expected cash flows to be received and determine if a credit loss has occurred. In the event that a credit loss has occurred, only the amount of impairment associated with the credit loss is recognized in earnings in the Consolidated Statements of Income. Amounts relating to factors other than credit losses are recorded in accumulated other comprehensive income (“AOCI”) within Stockholders’ Equity. Additional disclosures regarding the calculation of credit losses as well as factors considered by the investor in reaching a conclusion that an investment is not other-than-temporarily impaired are required.

The Company reviewed each investment that had an unrealized loss at June 30, 2012. An unrealized loss exists when the current fair value of an investment is less than its amortized cost basis. Unrealized losses on available for sale securities, that are deemed to be temporary, are recorded in AOCI, net of tax. Unrealized losses that are considered to be other-than-temporary are split between credit related and noncredit related impairments, with the credit related impairment being recorded as a charge against earnings and the noncredit related impairment being recorded in AOCI, net of tax.

The Company evaluates its pooled trust preferred securities, included in the table above in the row labeled “Other”, using an impairment model through an independent third party, which includes evaluating the financial condition of each counterparty. For single issuer trust preferred securities, the Company evaluates the issuer’s financial condition. The Company evaluates its mortgage-backed securities by reviewing the characteristics of the securities, including delinquency and foreclosure levels, projected losses at various loss severity levels and credit enhancement and coverage. In addition, private issue CMOs are evaluated using an impairment model through an independent third party. When an OTTI is identified, the portion of the impairment that is credit related is determined by management using the following methods: (1) for trust preferred securities, the credit related impairment is determined by using a discounted cash flow model from an independent third party, with the difference between the present value of the projected cash flows and the amortized cost basis of the security recorded as a credit related loss against earnings; (2) for mortgage-backed securities, credit related impairment is determined for each security by estimating losses based

on a set of assumptions, which includes delinquency and foreclosure levels, projected losses at various loss severity levels, credit enhancement and coverage; and (3) for private issue CMOs, through an impairment model from an independent third party and then recording those estimated losses as a credit related loss against earnings.

Corporate:

The unrealized losses in Corporate securities at June 30, 2012, consist of losses on six Corporate securities. The unrealized losses were caused by movements in interest rates. It is not anticipated that these securities would be settled at a price that is less than the amortized cost of the Company's investment. Each of these securities is performing according to its terms and, in the opinion of management, will continue to perform according to its terms. The Company does not have the intent to sell these securities and it is more likely than not the Company will not be required to sell the securities before recovery of the securities amortized cost basis. This conclusion is based upon considering the Company's cash and working capital requirements and contractual and regulatory obligations, none of which the Company believes would cause the sale of the securities. Therefore, the Company did not consider these investments to be other-than-temporarily impaired at June 30, 2012.

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Municipals:

The unrealized losses in Municipal securities at June 30, 2012, consist of losses on 12 municipal securities. The unrealized losses were caused by movements in interest rates. It is not anticipated that these securities would be settled at a price that is less than the amortized cost of the Company's investment. Each of these securities is performing according to its terms and, in the opinion of management, will continue to perform according to its terms. The Company does not have the intent to sell these securities and it is more likely than not the Company will not be required to sell the securities before recovery of the securities amortized cost basis. This conclusion is based upon considering the Company's cash and working capital requirements and contractual and regulatory obligations, none of which the Company believes would cause the sale of the securities. Therefore, the Company did not consider these investments to be other-than-temporarily impaired at June 30, 2012.

Other Securities:

The unrealized losses in Other Securities at June 30, 2012, consist of losses on one single issuer trust preferred security and two pooled trust preferred securities. The unrealized losses on such securities were caused by market interest volatility, a significant widening of credit spreads across markets for these securities and illiquidity and uncertainty in the financial markets. These securities are currently rated below investment grade. The pooled trust preferred securities do not have collateral that is subordinate to the classes the Company owns. The Company's management evaluates these securities using an impairment model, through an independent third party, that is applied to debt securities. In estimating OTTI losses, management considers: (1) the length of time and the extent to which the fair value has been less than amortized cost; (2) the current interest rate environment; (3) the financial condition and near-term prospects of the issuer, if applicable; and (4) the intent and ability of the Company to retain its investment in the security for a period of time sufficient to allow for any anticipated recovery in fair value. Additionally, management reviews the financial condition of each individual issuer within the pooled trust preferred securities. All of the issuers of the underlying collateral of the pooled trust preferred securities we reviewed are banks.

For each bank, our review included the following performance items:

- § Ratio of tangible equity to assets
- § Tier 1 Risk Weighted Capital
- § Net interest margin
- § Efficiency ratio for most recent two quarters
- § Return on average assets for most recent two quarters
- § Texas Ratio (ratio of non-performing assets plus assets past due over 90 days divided by tangible equity plus the reserve for loan losses)
- § Credit ratings (where applicable)
- § Capital issuances within the past year (where applicable)
- § Ability to complete Federal Deposit Insurance Corporation ("FDIC") assisted acquisitions (where applicable)

Based on the review of the above factors, we concluded that:

- § All of the performing issuers in our pools are well capitalized banks and do not appear likely to be closed by their regulators.
- § All of the performing issuers in our pools will continue as a going concern and will not default on their securities.

In order to estimate potential future defaults and deferrals, we segregated the performing underlying issuers by their Texas Ratio. We then reviewed performing issuers with Texas Ratios in excess of 50%. The Texas Ratio is a key indicator of the health of the institution and the likelihood of failure. This ratio compares the problem assets of the institution to the institution's available capital and reserves to absorb losses that are likely to occur in these assets. There was one issuer with a Texas Ratio in excess of 50% for which we concluded there would not be a default, primarily due to its current operating results and demonstrated ability to raise additional capital.

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There were no remaining performing issuers in our pooled trust preferred securities which had a Texas Ratio in excess of 75.00%. For the remaining issuers with a Texas Ratio between 50.00% and 74.99%, we estimated 25% of the related cash flows of the issuer would not be realized. We concluded that issuers with a Texas Ratio below 50.00% are considered healthy and there was a minimal risk of default. We assigned a zero default rate to these issuers. Our analysis also assumed that issuers currently deferring would default with no recovery and issuers that have defaulted will have no recovery.

We had an independent third party prepare a discounted cash flow analysis for each of these pooled trust preferred securities based on the assumptions discussed above. Other significant assumptions were: (1) one issuer will prepay in five years; (2) senior classes will not call the debt on their portions; and (3) use of the forward London Interbank Offered Rate (“LIBOR”) curve. The cash flows were discounted at the effective rate for each security. For each issuer that we assumed a 25% shortfall in the cash flows, the cash flow analysis eliminates 25% of the cash flow for each issuer effective immediately.

One of the pooled trust preferred securities is over 90 days past due and the Company has stopped accruing interest. The remaining pooled trust preferred security as well as the single issuer trust preferred security are both performing according to their terms. The Company also owns a pooled trust preferred security that is carried under the fair value option, where the unrealized losses are included in the Consolidated Statements of Income – Net gain (loss) from fair value adjustments. This security is over 90 days past due and the Company has stopped accruing interest.

It is not anticipated at this time that the one single issuer trust preferred security and the two pooled trust preferred securities would be settled at a price that is less than the amortized cost of the Company’s investment. Each of these securities is performing according to its terms; except for the pooled trust preferred securities for which the Company has stopped accruing interest as discussed above and, in the opinion of management based on the review performed at June 30, 2012, will continue to perform according to its terms. The Company does not have the intent to sell these securities and it is more likely than not the Company will not be required to sell the securities before recovery of the securities’ amortized cost basis. This conclusion is based upon considering the Company’s cash and working capital requirements and contractual and regulatory obligations, none of which the Company believes would cause the sale of the securities. Therefore, the Company did not consider the one single issuer trust preferred security and the two pooled trust preferred securities to be other-than-temporarily impaired at June 30, 2012.

At June 30, 2012, the Company held six trust preferred issues which had a current credit rating of at least one rating below investment grade. Two of those issues are carried under the fair value option and therefore, changes in fair value are included in the Consolidated Statement of Income – Net gain (loss) from fair value adjustments.

The following table details the remaining four trust preferred issues that were evaluated to determine if they were other-than-temporarily impaired at June 30, 2012. The class the Company owns in pooled trust preferred securities does not have any excess subordination.

Issuer	Performing	Amortized	Fair	Cumulative Credit Related	Deferrals/Defaults (1)		Current Lowest
					Actual as a Percentage of Original	Expected Percentage of Performing	

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Type	Class	Banks	Cost	Value	OTTI	Security	Collateral	Rating
(Dollars in thousands)								
Single issuer	n/a	1	\$300	\$272	\$ -	None	None	BB-
Single issuer	n/a	1	500	518	-	None	None	B +
Pooled issuer	B1	19	5,617	2,160	2,196	28.2 %	0.9 %	C
Pooled issuer	C1	19	3,645	1,875	1,542	25.6 %	0.0 %	C
<b>Total</b>			<b>\$10,062</b>	<b>\$4,825</b>	<b>\$ 3,738</b>			

(1) Represents deferrals/defaults as a percentage of the original security and expected deferrals/defaults as a percentage of performing issuers.

REMIC and CMO:

The unrealized losses in Real Estate Mortgage Investment Conduit (“REMIC”) and CMO securities at June 30, 2012 consist of four issues from the Federal Home Loan Mortgage Corporation (“FHLMC”), one issue from the Federal National Mortgage Association (“FNMA”), and seven private issues.

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The unrealized losses on the REMIC and CMO securities issued by FHLMC and FNMA were caused by movements in interest rates. It is not anticipated that these securities would be settled at a price that is less than the amortized cost of the Company's investment. Each of these securities is performing according to its terms and, in the opinion of management, will continue to perform according to its terms. The Company does not have the intent to sell these securities and it is more likely than not the Company will not be required to sell the securities before recovery of the securities amortized cost basis. This conclusion is based upon considering the Company's cash and working capital requirements and contractual and regulatory obligations, none of which the Company believes would cause the sale of the securities. Therefore, the Company did not consider these investments to be other-than-temporarily impaired at June 30, 2012.

The unrealized losses at June 30, 2012 on the seven REMIC and CMO securities issued by private issuers were caused by movements in interest rates, a significant widening of credit spreads across markets for these securities and illiquidity and uncertainty in the financial markets. Each of these securities has some level of credit enhancements and none are collateralized by sub-prime loans. Currently, three of these securities are performing according to their terms, with four of these securities remitting less than the full principal amount due. The principal loss for these four securities totaled \$0.8 million for the six months ended June 30, 2012. These losses were anticipated in the cumulative credit related OTTI charges recorded for these four securities.

Credit related impairment for mortgage-backed securities are determined for each security by estimating losses based on the following set of assumptions: (1) delinquency and foreclosure levels; (2) projected losses at various loss severity levels; and (3) credit enhancement and coverage. Based on these reviews, an OTTI charge was recorded during the three and six months ended June 30, 2012 on five private issue CMOs of \$6.2 million before tax, of which \$0.8 million was charged against earnings in the Consolidated Statements of Income and \$5.4 million before tax (\$3.1 million after-tax) was recorded in AOCL.

The portion of the above mentioned OTTI, recorded during the three and six months ended June 30, 2012, that was related to credit losses was calculated using the following significant assumptions: (1) delinquency and foreclosure levels of 11%-18%; (2) projected loss severity of 40%-50%; (3) assumed default rates of 6%-10% for the first 12 months, 2%-7% for the next 12 months, 2%-8% for the next 12 months and 2% thereafter; and (4) prepayment speeds of 6%-20%.

It is not anticipated at this time that the two private issue CMOs for which an OTTI charge during the three months ended June 30, 2012 was not recorded, would be settled at a price that is less than the current amortized cost of the Company's investment. Both of these securities are performing according to their terms and in the opinion of management, will continue to perform according to their terms. The Company does not have the intent to sell these securities and it is more likely than not the Company will not be required to sell the securities before recovery of the securities amortized cost basis. This conclusion is based upon considering the Company's cash and working capital requirements and contractual and regulatory obligations, none of which the Company believes would cause the sale of the securities. Therefore, the Company did not consider these two investments to be other-than-temporarily impaired at June 30, 2012.

At June 30, 2012, the Company held 15 private issue CMOs which had a current credit rating of at least one rating below investment grade. Five of those issues are carried under the fair value option and therefore, changes in fair value are included in the Consolidated Statement of Income – Net gain (loss) from fair value adjustments.





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The following table details the remaining 10 private issue CMOs that were evaluated to determine if they were other-than-temporarily impaired at June 30, 2012:

Security	Amortized Cost	Fair Value	Outstanding Principal	Cumulative OTTI Charges Recorded	Year of Issuance	Maturity	Current Lowest Rating	Collateral Located in:					Average FICO Score	
								CA	FL	VA	NY	NJ		TX
1	\$10,610	\$7,962	\$11,842	\$3,470	2006	05/25/36	D	42%		15%				719
2	4,879	3,662	5,168	727	2006	08/19/36	D	55%						737
3	4,907	4,022	5,466	1,107	2006	08/25/36	D	36%	15%					713
4	3,708	3,257	4,314	780	2006	08/25/36	D	37%	13%	12%	12%			724
5	2,960	2,720	3,270	249	2006	03/25/36	CC	38%						727
6	1,502	1,522	1,511	-	2005	12/25/35	B-	40%						