NATIONAL SECURITY GROUP INC
Form 10-Q
August 15, 2013
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For Quarterly Period Ended June 30, 2013

or

o 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 0-18649

The National Security Group, Inc.
(Exact name of registrant as specified in its charter)

Delaware (State or Other Jurisdiction of Incorporation or Organization)	63-1020300 (IRS Employer Identification No.)
661 East Davis Street Elba, Alabama (Address of principal executive offices)	36323 (Zip-Code)

Registrant’s Telephone Number including Area Code (334) 897-2273

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). þ Yes o No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer (as defined in rule 12b-2 of the Act). (Check One) : Large accelerated filer o Accelerated filer o Non-accelerated filer o 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

As of August 14, 2013, there were 2,494,480 shares, $1.00 par value, of the registrant's common stock outstanding.

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THE NATIONAL SECURITY GROUP, INC.

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Cautionary Statement Regarding Forward-Looking Statements

Any statement contained in this report which is not a historical fact, or which might otherwise be considered an opinion or projection concerning the Company or its business, whether expressed or implied, is meant as and should be considered a forward-looking statement as that term is defined in the Private Securities Litigation Reform Act of 1995. The following report contains forward-looking statements that are not strictly historical and that involve risks and uncertainties. Such statements include any statements containing the words “expect,” “plan,” “estimate,” “anticipate” or other words of a similar nature. Management cautions investors about forward-looking statements. Forward-looking statements involve certain evaluation criteria, such as risks, uncertainties, estimates, and/or assumptions made by individuals informed of the Company and industries in which we operate. Any variation in the preceding evaluation criteria could cause actual results to differ materially from those expressed or implied by such forward-looking statements. These risks and uncertainties include, without limitation, the following:

The insurance industry is highly competitive, and the Company encounters significant competition in all lines of business from other insurance companies. Many of the competing companies have more abundant financial resources than the Company.

Insurance is a highly regulated industry. It is possible that legislation may be enacted, which would have an adverse effect on the Company's business.

The Company is subject to regulation by state governments for each of the states in which it conducts business. The Company cannot predict the subject of any future regulatory initiative(s) or its (their) impact on the Company's business.

The Company is rated by various insurance rating agencies. If a rating is downgraded from its current level by one of these agencies, sales of the Company's products and stock price could be adversely impacted.

The Company's financial results are adversely affected by increases in policy claims received by the Company. While a manageable risk, this fluctuation is often unpredictable.

The Company's investments are subject to a variety of risks. Investments are subject to defaults and changes in market value. Market value can be affected by changes in interest rates, market performance and the economy.

The Company mitigates risk associated with life policies through implementing effective underwriting and reinsurance strategies. These factors mitigate, not eliminate, risk related to mortality and morbidity exposure. The Company has established reserves for claims and future policy benefits based on amounts determined by independent actuaries. There is no assurance that these estimated reserves will prove to be sufficient or that the Company will not incur claims exceeding reserves, which could result in operating losses and loss of capital.

The Company mitigates risk associated with property and casualty policies through implementing effective underwriting and reinsurance strategies. The Company obtains reinsurance which increases underwriting capacity and limits the risk associated with policy claims. The Company is subject to credit risk with regard to reinsurers as reinsurance does not alleviate the Company's liability to its insured's for the ceded risks. The Company utilizes a third-party to develop a reinsurance treaty with reinsurers who are reliable and financially stable. However, there is no guarantee that booked reinsurance recoverable will actually be recovered. A reinsurer's insolvency or inability to make payments due could have a material adverse impact on the financial condition of the Company.

The Company's ability to continue to pay dividends to shareholders is contingent upon profitability and capital adequacy of the insurance subsidiaries. The insurance subsidiaries operate under regulatory restrictions that could

limit the ability to fund future dividend payments of the Company. An adverse event or series of events could materially impact the ability of the insurance subsidiaries to fund future dividends, and consequently, the Board of Directors would have to suspend the declaration of dividends to shareholders.

The Company is subject to the risk of adverse settlements or judgments resulting from litigation of contested claims. It is difficult to predict or quantify the expected results of litigation because the outcome depends on decisions of the court and jury that are based on facts and legal arguments presented at the trial.

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Part I. FINANCIAL INFORMATION
Item 1. Financial Statements

THE NATIONAL SECURITY GROUP, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS (In thousands)

	June 30, 2013	December 31, 2012
ASSETS	(UNAUDITED)	
Investments		
Fixed maturities held-to-maturity, at amortized cost (estimated fair value: 2013 - $1,199; 2012 - $1,609)	$ 1,137	$ 1,502
Fixed maturities available-for-sale, at estimated fair value (cost: 2013 - $74,575; 2012 -$71,678)	76,360	76,294
Equity securities available-for-sale, at estimated fair value (cost: 2013 - $2,466; 2012 - $3,191)	4,275	5,132
Trading securities	19	40
Mortgage loans on real estate, at cost	379	383
Investment real estate, at book value	5,550	5,757
Policy loans	1,359	1,317
Company owned life insurance	5,783	5,931
Other invested assets	3,650	3,777
Total Investments	98,512	100,133
Cash	3,841	6,779
Accrued investment income	812	788
Policy receivables and agents' balances, net	11,290	9,006
Reinsurance recoverable	1,533	1,541
Deferred policy acquisition costs	9,044	9,097
Property and equipment, net	2,258	2,392
Deferred income tax asset	6,465	4,997
Other assets	1,161	983
Total Assets	$ 134,916	$ 135,716
LIABILITIES AND SHAREHOLDERS' EQUITY		
Property and casualty benefit and loss reserves	$ 9,738	$ 11,214
Accident and health benefit and loss reserves	2,361	2,341
Life and annuity benefit and loss reserves	30,044	30,041
Unearned premiums	28,187	25,777
Policy and contract claims	716	995
Other policyholder funds	1,422	1,417
Short-term notes payable and current portion of long-term debt	1,367	1,292
Long-term debt	25,639	25,339
Accrued income taxes	416	296
Other liabilities	5,745	6,777
Total Liabilities	105,635	105,489
Contingencies		
Shareholders' equity		
Common stock	2,494	2,467
Additional paid-in capital	5,147	4,951

Accumulated other comprehensive income	1,723	3,325
Retained earnings	19,917	19,484
Total Shareholders' Equity	29,281	30,227
Total Liabilities and Shareholders' Equity	$ 134,916	$ 135,716

The Notes to Condensed Consolidated Financial Statements (Unaudited) are an integral part of these statements.

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THE NATIONAL SECURITY GROUP, INC.

CONDENSED CONSOLIDATED STATEMENTS OF INCOME (LOSS) (UNAUDITED)
(In thousands, except per share amounts)

	Three months ended June 30,		Six months ended June 30,	
	2013	2012	2013	2012
REVENUES				
Net premiums earned	$13,038	$12,533	$25,972	$26,029
Net investment income	728	1,066	1,812	2,201
Net realized investment gains	1,030	865	1,057	1,071
Other income	145	193	317	390
Total Revenues	14,941	14,657	29,158	29,691
EXPENSES				
Policyholder benefits and settlement expenses	8,260	7,976	17,811	15,821
Amortization of deferred policy acquisition costs	923	915	1,865	1,731
Commissions	1,486	2,018	3,468	3,974
General and administrative expenses	2,201	1,835	4,043	4,323
Litigation settlement and defense costs	—	12,670	—	13,259
Taxes, licenses and fees	474	438	960	930
Interest expense	435	288	877	580
Total Expenses	13,779	26,140	29,024	40,618
Income (Loss) Before Income Taxes	1,162	(11,483)	134	(10,927)
INCOME TAX EXPENSE (BENEFIT)				
Current	88	145	220	173
Deferred	109	(4,322)	(642)	(4,325)
	197	(4,177)	(422)	(4,152)
Net Income (Loss)	$965	$(7,306)	$556	$(6,775)
INCOME (LOSS) PER COMMON SHARE	$0.39	$(2.96)	$0.23	$(2.75)
DIVIDENDS DECLARED PER SHARE	$0.025	$0.10	$0.05	$0.20

The Notes to Condensed Consolidated Financial Statements (Unaudited) are an integral part of these statements.

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THE NATIONAL SECURITY GROUP, INC.

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS (UNAUDITED)
(In thousands)

	Three months ended June 30,		Six months ended June 30,	
	2013	2012	2013	2012
Net income (loss)	$965	$(7,306)	$556	$(6,775)
Other comprehensive loss, net of tax				
Changes in:				
Unrealized gains (losses) on securities, net of reclassification adjustment of $698 and $704 for the six months ended 2013 and 2012, respectively and $680 and $568 for the three months ended 2013 and 2012, respectively	(2,482)	(201)	(1,956)	76
Unrealized gain (loss) on interest rate swap	302	(244)	354	(159)
Other comprehensive loss, net of tax	(2,180)	(445)	(1,602)	(83)
Comprehensive loss	$(1,215)	$(7,751)	$(1,046)	$(6,858)

The Notes to Condensed Consolidated Financial Statements (Unaudited) are an integral part of these statements.

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THE NATIONAL SECURITY GROUP, INC.

CONDENSED CONSOLIDATED STATEMENTS OF SHAREHOLDERS’ EQUITY (UNAUDITED)
Six months ended June 30, 2013 (In thousands)

	Total	Retained Earnings	Accumulated Other Comprehensive Income	Common Stock	Additional Paid-in Capital
Balance at December 31, 2012	$30,227	$19,484	$3,325	$2,467	$4,951
Net income for the six months ended June 30, 2013	556	556			
Other comprehensive loss (net of tax)	(1,602)		(1,602)		
Common stock issued	27			27	
Additional paid-in capital	196				196
Cash dividends	(123)	(123)			
Balance at June 30, 2013 (UNAUDITED):	$29,281	$19,917	$1,723	$2,494	$5,147

The Notes to Condensed Consolidated Financial Statements (Unaudited) are an integral part of these statements.

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THE NATIONAL SECURITY GROUP, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED) (In thousands)

	Six months ended June 30,	
	2013	2012
Cash Flows from Operating Activities		
Net income (loss)	$556	$(6,775)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation expense and amortization/accretion, net	398	286
Increase in cash surrender value of company owned life insurance	148	(171)
Net realized gains on investments	(1,057)	(1,071)
Deferred income taxes	(642)	(4,325)
Amortization of deferred policy acquisition costs	1,865	1,731
Changes in assets and liabilities:		
Change in accrued investment income	(24)	(70)
Change in reinsurance recoverable	8	818
Policy acquisition costs deferred	(1,812)	(1,876)
Change in accrued income taxes/recoverable	120	173
Change in net policy liabilities and claims	(1,614)	(1,376)
Change in other assets/liabilities, net	(587)	(345)
Change in litigation settlement	—	13,000
Other, net	233	18
Net cash provided by (used in) operating activities	(2,408)	17
Cash Flows from Investing Activities		
Purchase of:		
Available-for-sale securities	(9,619)	(15,195)
Trading securities and short-term investments	—	(40)
Real estate held for investment	—	(32)
Property and equipment	(67)	(161)
Proceeds from sale or maturities of:		
Held-to-maturity securities	364	994
Available-for-sale securities	8,319	17,572
Trading securities and short-term investments	—	83
Real estate held for investment	207	—
Property and equipment	6	6
Other invested assets, net	3	41
Net cash provided by (used in) investing activities	(787)	3,268
Cash Flows from Financing Activities		
Change in other policyholder funds	5	21
Increase in long-term debt	300	—
Change in short-term notes payable	75	140
Dividends paid	(123)	(494)
Net cash provided by (used in) financing activities	257	(333)
Net change in cash and cash equivalents	(2,938)	2,952
Cash and cash equivalents, beginning of year	6,779	3,393
Cash and cash equivalents, end of period	$3,841	$6,345

The Notes to Condensed Consolidated Financial Statements (Unaudited) are an integral part of these statements.

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THE NATIONAL SECURITY GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

NOTE 1 – SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation and Basis of Presentation
The accompanying condensed consolidated financial statements include the accounts of The National Security Group, Inc. (the Company) and its wholly-owned subsidiaries: National Security Insurance Company (NSIC), National Security Fire and Casualty Company (NSFC) and NATSCO, Inc. (NATSCO). NSFC includes a wholly-owned subsidiary - Omega One Insurance Company (Omega). In the opinion of Management, the unaudited financial statements presented herein include all accruals necessary to present fairly the Company’s financial position at June 30, 2013, and the results of operations, cash flows and changes in shareholders’ equity for the interim periods ended June 30, 2013 and 2012, in conformity with accounting principles generally accepted in the United States. All significant intercompany transactions and accounts have been eliminated. The condensed consolidated financial statements of the Company presented herein have not been audited by independent auditors, except for the Consolidated Balance Sheet at December 31, 2012. Financial statements and notes to condensed consolidated financial statements included in this Form 10-Q report should be read in conjunction with the Company’s 2012 Form 10-K report, as certain notes and other pertinent information have been abbreviated or omitted in this report. Financial results for the three-month and six-month period ended June 30, 2013 are not necessarily indicative of future results.

Description of Business
NSIC is licensed in the states of Alabama, Florida, Georgia, Mississippi, South Carolina, Tennessee and Texas and was organized in 1947 to provide life and burial insurance policies to the home service market. Business is now produced by both company and independent agents. Primary products include ordinary life, accident and health, supplemental hospital, and cancer insurance products.

NSFC is licensed in Alabama, Arkansas, Florida, Georgia, Kentucky, Mississippi, Oklahoma, South Carolina, Tennessee and West Virginia. In addition, NSFC operates on a surplus lines basis in Louisiana, Missouri, and Texas. NSFC operates in various property and casualty lines, the most significant of which are: dwelling property fire and extended coverage, homeowners and mobile homeowners.

Omega is licensed in the states of Alabama and Louisiana. Omega operates in the property and casualty homeowners line of business.

The Company is incorporated under the laws of the State of Delaware. Its common stock is traded on the NASDAQ Global Market under the ticker symbol NSEC. Pursuant to the regulations of the United States Securities and Exchange Commission (SEC), the Company is considered a “Smaller Reporting Company” as defined by SEC Rule 12b-2 of the Exchange Act. The Company has elected to comply with the scaled disclosure requirements of Regulation S-K and only two years of financial statements are included herein.

Use of Estimates
The preparation of financial statements in conformity with generally accepted accounting principles 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 consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Among the more significant estimates included in these consolidated financial statements are reserves for future policy benefits, liabilities for losses and loss adjustment expenses, reinsurance recoverable asset on associated loss and loss adjustment expense liabilities, deferred policy acquisition costs, deferred income tax assets and liabilities, assessments of other-than-temporary impairments on

investments and accruals for contingencies. Actual results could differ from those estimates.

Investments

The Company's securities are classified as follows:

- Securities Held-to-Maturity. Bonds, notes and redeemable preferred stock for which the Company has the positive intent and ability to hold to maturity are reported at cost, adjusted for amortization of premiums and accretion of discounts which are recognized in interest income using methods which approximate level yields over the period to maturity.

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THE NATIONAL SECURITY GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

- Securities Available-for-Sale. Bonds, notes, common stock and non-redeemable preferred stock, not classified as either held-to-maturity or trading, are reported at fair value and adjusted for other-than-temporary declines in fair value.

- Trading Securities. Trading securities are classified as such on the balance sheet and reported at fair value.

Unrealized gains and losses on investments, net of tax, on securities available-for-sale are reflected directly in shareholders' equity as a component of accumulated other comprehensive income (loss), and accordingly, have no effect on operating results until realized.

Changes in fair value of trading securities are recognized in net income.

Realized gains and losses on the sale of investments available-for-sale are determined using the specific-identification method and include write downs on available-for-sale investments considered to have other-than-temporary declines in market value.

When a fixed maturity security has a decline in value, where fair value is below amortized cost, an other-than-temporary impairment (OTTI) is triggered in circumstances where:

- the Company has the intent to sell the security

- it is more likely-than-not that the Company will be required to sell the security before recovery of its amortized cost basis

- the Company does not expect to recover the entire amortized cost basis of the security.

If the Company intends to sell the security or if it is more-likely-than-not the Company will be required to sell the security before recovery, an OTTI is recognized as a realized loss in the income statement equal to the difference between the security's amortized cost and its fair value. If the Company does not intend to sell the security or it is not more-likely-than not that the Company will be required to sell the security before recovery, the OTTI is separated into an amount representing the credit loss, which is recognized as a realized loss in the statement of operations, and the amount related to all other factors, which is recognized in other comprehensive income.

When an equity security has a decline in value, where fair value is below cost, that is deemed to be other-than-temporary, the Company reduces the book value of the security to its current fair value, recognizing the decline as a realized loss in the statement of operations. Any future increases in the market value of investments written down are reflected as changes in unrealized gains as part of accumulated other comprehensive income within shareholders' equity.

Interest on fixed income securities is credited to income as it accrues on the principal amounts outstanding adjusted for amortization of premiums and accretion of discounts computed utilizing the effective interest rate method. Premiums and discounts on mortgage backed securities are amortized or accreted using anticipated prepayments with changes in anticipated prepayments accounted for prospectively. The model used to determine anticipated prepayment assumptions for mortgage backed securities uses separate home sale, refinancing, curtailment and pay-off assumptions derived from a variety of industry sources. Mortgage backed security valuations are subject to prospective adjustments

in yield due to changes in prepayment assumptions. The utilization of the prospective method will result in a recalculated effective yield that will equate the carrying amount of the investment to the present value of the projected future cash flows. The recalculated yield is used to accrue income on investments for subsequent periods.

Mortgage loans and policy loans are stated at the unpaid principal balance of such loans, net of any related allowance for uncollectible amounts.

Investment real estate is reported at cost, less allowances for depreciation computed on the straight-line basis. Investment real estate consists primarily of timberland and undeveloped commercial real estate. Real estate is carried at cost.

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THE NATIONAL SECURITY GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Other investments consist primarily of investments in notes and equity investments in limited liability companies. The Company has no influence or control over the operating or financial policies of the investee limited liability companies, and consequently, these investments are accounted for using the cost method.

The Company owns life insurance (COLI) contracts on certain management and supervisory employees each having a face amount of approximately $2,000,000. The Company's original investment in company owned life insurance was $5,000,000. The primary purpose of the program is to offset future employee benefit expenses through earnings on the cash value of the policies. The Company is the owner and principal beneficiary of these policies. The life insurance contracts are carried at their current cash surrender value. Cash surrender value at June 30, 2013 and December 31, 2012 was $5,783,000 and $5,931,000, respectively. Changes in cash surrender values are included in investment income in the current period. The change in surrender value included in earnings for the three-month periods ended June 30, 2013 and 2012 was a decline of $198,000 and an increase of $54,000, respectively. The change in surrender value included in earnings for the six-month periods ended June 30, 2013 and 2012 was a decline of $148,000 and an increase of $171,000, respectively. Death proceeds from the contracts are recorded when the proceeds become payable under the terms of the policy. There were no proceeds received from the COLI during 2013 or 2012.

Cash and short-term investments are carried at cost, which approximates market value.

Investments with other-than-temporary impairment in value are written down to estimated realizable values and losses recognized in the determination of operating results. The fair value of the investment becomes its new cost basis.

Fair Values of Financial Instruments
The Company uses the following methods and assumptions to estimate fair values:

Investments

- Fixed income security fair values are based on quoted market prices when available. If not available, fair values are based on values obtained from investment brokers and independent pricing services.

- Equity security fair values are based on quoted market prices.

- Multiple observable inputs are not available for some of our investments, primarily private placements and limited partnerships. Management values these investments either using non-binding broker quotes or pricing models that utilize market based assumptions that have limited observable inputs. These investments compose less than 1% of total assets.

Receivables and reinsurance recoverable - The carrying amounts reported approximate fair value.

Interest rate swaps - The estimated fair value of the interest rate swaps is based on valuations received from financial institution counterparties.

Trust preferred securities obligations and line of credit obligations - The carrying amounts reported for these instruments are equal to the principal balance outstanding and approximate their fair value.

Policy Receivables
Receivable balances are reported at unpaid balances, less a provision for credit losses.

Accounts Receivable
Accounts receivable are reported at net realizable value. Management determines the allowance for doubtful accounts based on historical losses and current economic conditions. On a continuing basis, management analyzes delinquent receivables, and once these receivables are determined to be uncollectible, they are written off through a charge against an existing allowance account or against earnings.

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THE NATIONAL SECURITY GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Property and Equipment
Property and equipment is carried at cost less accumulated depreciation and includes expenditures that substantially increase the useful lives of existing property and equipment. Significant costs incurred for internally developed software are capitalized and amortized over estimated useful lives of 3 years. Maintenance, repairs, and minor renovations are charged to expense as incurred. Upon sale or retirement of property and equipment, the costs and related accumulated depreciation are eliminated from the respective account and the resulting gain or loss is included in the results of operations. The Company provides for depreciation of property and equipment using the straight-line method designed to amortize costs over estimated useful lives. Estimated useful lives range up to 40 years for buildings and from 3-10 years for electronic data processing equipment and furniture and fixtures. Property and equipment are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable.

Statement of Cash Flows
For purposes of reporting cash flows, cash includes cash-on-hand, demand deposits with banks and overnight investments.

Premium Revenue
Life insurance premiums are recognized as revenues when due. Property and casualty insurance premiums include direct writings plus reinsurance assumed less reinsurance ceded and are recognized on a pro rata basis over the terms of the policies. Unearned premiums represent that portion of direct premiums written that are applicable to the unexpired terms of policies in force and is reported as a liability. Prepaid reinsurance premiums represent the unexpired portion of premiums ceded to reinsurers and are reported as an asset.

Deferred Policy Acquisition Costs
The costs of acquiring new insurance business are deferred and amortized over the lives of the policies. Deferred costs include commissions, premium taxes, other agency compensation and expenses, and other underwriting expenses directly related to the level of new business produced.

Acquisition costs relating to life contracts are amortized over the premium paying period of the contracts, or the first renewal period of term policies, if earlier. Assumptions utilized in amortization are consistent with those utilized in computing policy liabilities.

The method of computing the deferred policy acquisition costs for property and casualty policies limits the amount deferred to a percentage of related unearned premiums.

Earnings Per Share
Earnings per share of common stock is based on the weighted average number of shares outstanding during each year. The adjusted weighted average shares outstanding were 2,467,062 in 2013 and 2,466,600 in 2012.

Reinsurance
The Company's insurance operations re-insure certain risks in order to limit losses, minimize exposure to large risks, provide additional capacity for future growth and effect business-sharing arrangements. See Note 10 for additional information regarding the Company's reinsurance practices.

Income Taxes

The Company uses the asset and liability method of accounting for income taxes. Deferred income taxes arise from the recognition of temporary differences between financial statement carrying amounts and the tax bases of the Company's assets and liabilities and operating loss carry-forwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. A valuation allowance is provided when it is more likely than not that some portion of the deferred tax asset will not be realized. The effect of a change in tax rates is recognized in the period the new rate is enacted.

The Company evaluates all tax positions taken on its U.S. federal income tax return. No material uncertainties exist for any tax positions taken by the Company.

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THE NATIONAL SECURITY GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Contingencies
Liabilities for loss contingencies arising from, but not limited to, litigation, claims, assessments, fines and penalties are recorded when it is probable that a liability has been incurred and the amount of the assessment and/or remediation can be reasonably estimated. Significant attorney fees are estimated and recorded when incurred.

Reclassifications
Certain 2012 amounts have been reclassified from the prior year consolidated financial statements to conform to the 2013 presentation.

Advertising
The Company expenses advertising costs as incurred. Advertising costs charged to expense were $31,000 for the three months ended June 30, 2013 ($28,000 for the three months ended June 30, 2012). Advertising costs charged to expense were $84,000 for the six months ended June 30, 2013 ($61,000 for the six months ended June 30, 2012). Advertising cost consists primarily of agent convention expense and print media.

Concentration of Credit Risk
The Company maintains cash balances which are generally held in non-interest bearing demand deposit accounts. Through December 31, 2012, these balances were insured by the FDIC with no balance limits. On January 1, 2013, $250,000 per account balance limits were reinstated. At June 30, 2013, the net amount exceeding FDIC insured limits was $2,347,000 at one financial institution. The Company has not experienced any losses in such accounts. Management of the Company reviews financial information of the financial institution on a quarterly basis and believes the Company is not exposed to any significant credit risk on cash and cash equivalents.

Policy receivables are reported at unpaid balances. Policy receivables are generally offset by associated unearned premium liabilities and are not subject to significant credit risk. Receivables from agents, less provision for credit losses, are composed of balances due from independent agents. At June 30, 2013, the single largest balance due from one agent totaled $1,485,000.

Reinsurance contracts do not relieve the Company of its obligations to policyholders. A failure of a reinsurer to meet their obligation could result in losses to the insurance subsidiaries. Allowances for losses are established if amounts are believed to be uncollectible. At June 30, 2013 and December 31, 2012, no amounts were deemed uncollectible. The Company, at least annually, evaluates the financial condition of all reinsurers and evaluates any potential concentrations of credit risk. At June 30, 2013, management does not believe the Company is exposed to any significant credit risk related to its reinsurance program.

Recently Adopted Accounting Standards

Disclosures about Offsetting Assets and Liabilities for Financial Instruments and Derivative Instruments
In December 2011, the FASB issued guidance requiring expanded disclosures, including both gross and net information, for financial instruments and derivative instruments that are either offset in the reporting entity's financial statements or those that are subject to an enforceable master netting arrangement or similar agreement. The Company adopted the new guidance on January 1, 2013 and applied it retrospectively. The guidance impacts disclosures only and will have no impact on the Company's results of operations or financial position. The Company does not have any derivative instruments subject to master netting arrangements at June 30, 2013.

In February 2013, the FASB issued an accounting standards update that requires additional disclosures for reclassification adjustments from accumulated other comprehensive income (AOCI). These additional disclosures include changes in AOCI balances by component and significant items reclassified out of AOCI. These disclosures must be presented either on the face of the affected financial statement or in the notes to the financial statements. The disclosures are effective beginning in the first quarter of 2013 and are to be provided on a prospective basis. These disclosures are presented in Note 12.

Intangibles-Goodwill and Other

In July 2012, the FASB issued guidance related to impairment of indefinite-lived intangible assets other than goodwill. The new guidance allows an entity to first make a qualitative assessment of whether it is more likely than not that the

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fair value of an indefinite-lived intangible asset is less than its carrying amount before applying the quantitative impairment test. An entity is required to perform the quantitative test only if it determines that it is more likely than not that the fair value of an indefinite-lived intangible asset is less than its carrying amount. The Company adopted this guidance January 1, 2013. No interim testing was required as of June 30, 2013, and we do not expect a material effect on results of operations or financial position following annual testing.

NOTE 2 – VARIABLE INTEREST ENTITIES

The Company holds a passive interest in a limited partnership that is considered to be a Variable Interest Entity (VIE) under the provisions of FIN 46(R). The Company is not the primary beneficiary of the entity and is not required to consolidate under FIN 46(R). The entity is a private placement investment fund formed for the purpose of investing in private equity investments. The Company owns less than 1% of the limited partnership. The carrying value of the investment totals $325,000 and is included as a component of Other Invested Assets in the accompanying condensed consolidated balance sheets.

In December 2005, the Company formed National Security Capital Trust I, a statutory trust created under the Delaware Statutory Trust Act, for the sole purpose of issuing, in private placement transactions, $9,000,000 of trust preferred securities (TPS) and using the proceeds thereof, together with the equity proceeds received from the Company in the initial formation of the Trust, to purchase $9,279,000 of variable rate subordinated debentures issued by the Company. The Company owns all voting securities of the Trust and the subordinated debentures are the sole assets of the Trust. The Trust will meet the obligations of the TPS with the interest and principal paid on the subordinated debentures. The Company received net proceeds from the TPS transactions, after commissions and other costs of issuance, of $9,005,000. The Company also holds all the voting securities issued by the Trust and such trusts are considered to be VIE's. The Trust is not consolidated because the Company is not the primary beneficiary of the trust. The Subordinated Debentures, disclosed in Note 7, are reported in the accompanying Consolidated Balance Sheets as a component of long-term debt. The Company's equity investments in the Trust total $279,000 and are included in Other Assets in the accompanying condensed consolidated balance sheets.

In June 2007, the Company formed National Security Capital Trust II for the sole purpose of issuing, in private placement transactions, $3,000,000 of trust preferred securities (TPS) and using the proceeds thereof, together with the equity proceeds received from the Company in the initial formation of the Trust, to purchase $3,093,000 unsecured junior subordinated deferrable interest debentures. The Company owns all voting securities of the Trust and the subordinated debentures are the sole assets of the Trust. The Trust will meet the obligations of the TPS with the interest and principal paid on the subordinated debentures. The Company received net proceeds from the TPS transactions, after commissions and other costs of issuance, of $2,995,000. The Company also holds all the voting securities issued by the Trust and such trusts are considered to be VIE's. The Trust is not consolidated because the Company is not the primary beneficiary of the Trust. The Subordinated Debentures, disclosed in Note 7, are reported in the accompanying condensed consolidated balance sheets as a component of long-term debt. The Company's equity investments in the Trust total $93,000 and are included in Other Assets in the accompanying condensed consolidated balance sheets.

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NOTE 3 – INVESTMENTS

The amortized cost and aggregate fair values of investments in available-for-sale securities as of June 30, 2013 are as follows:

Available-for-sale securities:	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Corporate debt securities	$34,281	$1,704	$417	$35,568
Trust preferred securities	538	6	—	544
Mortgage backed securities	8,765	94	318	8,541
Private label mortgage backed securities	6,206	180	10	6,376
Obligations of states and political subdivisions	16,908	742	128	17,522
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	7,877	159	227	7,809
Total fixed maturities	74,575	2,885	1,100	76,360
Equity securities	2,466	2,238	429	4,275
Total	$77,041	$5,123	$1,529	$80,635

The amortized cost and aggregate fair values of investments in held-to-maturity securities as of June 30, 2013 are as follows:

Held-to-maturity securities:	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Mortgage backed securities	$870	$53	$—	$923
Obligations of states and political subdivisions	145	1	—	146
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	122	8	—	130
Total	$1,137	$62	$—	$1,199

The amortized cost and aggregate fair values of investments in available-for-sale securities as of December 31, 2012 are as follows:

Available-for-sale securities:	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Corporate debt securities	$31,387	$2,430	$80	$33,737
Trust preferred securities	537	50	—	587
Mortgage backed securities	8,595	175	85	8,685
Private label mortgage backed securities	7,679	294	9	7,964
Obligations of states and political subdivisions	16,160	1,359	3	17,516
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	7,320	487	2	7,805
Total fixed maturities	71,678	4,795	179	76,294
Equity securities	3,191	2,398	457	5,132
Total	$74,869	$7,193	$636	$81,426

The amortized cost and aggregate fair values of investments in held-to-maturity securities as of December 31, 2012 are as follows:

Held-to-maturity securities:	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Mortgage backed securities	$1,194	$91	$—	$1,285
Obligations of states and political subdivisions	145	2	—	147
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	163	14	—	177
Total	$1,502	$107	$—	$1,609

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The amortized cost and aggregate fair value of debt securities at June 30, 2013, by contractual maturity, are presented in the following table. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	(Dollars in Thousands)	
	Amortized Cost	Fair Value
Available-for-sale securities:		
Due in one year or less	$1,695	$1,737
Due after one year through five years	14,867	15,990
Due after five years through ten years	24,381	24,823
Due after ten years	33,632	33,810
Total	$74,575	$76,360
Held-to-maturity securities:		
Due in one year or less	$—	$—
Due after one year through five years	445	465
Due after five years through ten years	27	28
Due after ten years	665	706
Total	$1,137	$1,199

A summary of securities available-for-sale with unrealized losses as of June 30, 2013, along with the related fair value, aggregated by the length of time that investments have been in a continuous unrealized loss position, is as follows:

	Less than 12 months		12 months or longer		Total		
June 30, 2013	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Total Securities in a Loss Position
Fixed maturities							
Corporate debt securities	$10,246	$380	$974	$37	$11,220	$417	25
Mortgage backed securities	4,608	287	856	31	5,464	318	16
Private label mortgage backed securities	498	10	—	—	498	10	3
Obligations of state and political subdivisions	2,824	113	342	15	3,166	128	9
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	3,925	178	449	49	4,374	227	8
Equity securities	—	—	857	429	857	429	1
	$22,101	$968	$3,478	$561	$25,579	$1,529	62

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A summary of securities available-for-sale with unrealized losses as of December 31, 2012, along with the related fair value, aggregated by the length of time that investments have been in a continuous unrealized loss position, is as follows:

	Less than 12 months		12 months or longer		Total		
December 31, 2012	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Total Securities in a Loss Position
Fixed maturities							
Corporate debt securities	$2,226	$31	$963	$49	$3,189	$80	7
Mortgage backed securities	2,904	77	165	8	3,069	85	8
Private label mortgage backed securities	206	8	65	1	271	9	2
Obligations of state and political subdivisions	356	3	—	—	356	3	1
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	495	2	—	—	495	2	1
Equity securities	—	—	829	457	829	457	1
	$6,187	$121	$2,022	$515	$8,209	$636	20

There were no securities held-to-maturity with unrealized losses as of June 30, 2013 and December 31, 2012.

The Company conducts periodic reviews to identify and evaluate securities in an unrealized loss position in order to identify other-than-temporary impairments. For securities in an unrealized loss position, the Company assesses whether the Company has the intent to sell the security or more-likely-than-not will be required to sell the security before the anticipated recovery. If either of these conditions is met, the Company is required to recognize an other-than-temporary impairment with the entire unrealized loss reported in earnings. For securities in an unrealized loss position that do not meet these conditions, the Company assesses whether the impairment of a security is other-than-temporary. If the impairment is determined to be other-than-temporary, the Company is required to separate the other-than-temporary impairments into two components: the amount representing the credit loss and the amount related to all other factors. The credit loss is the portion of the amortized book value in excess of the net present value of the projected future cash flows discounted at the effective interest rate implicit in the debt security prior to impairment. The credit loss component of other-than-temporary impairments is reported in earnings, whereas the amount relating to factors other than credit losses are recorded in other comprehensive income, net of taxes.

Management has evaluated each security in a significant unrealized loss position. The Company has no material exposure to sub-prime mortgage loans and less than 4% of the fixed income investment portfolio is rated below investment grade. In evaluating whether or not the equity loss positions were other-than-temporary impairments, Management evaluated financial information on each company and where available, reviewed analyst reports from at least two independent sources. Based on a review of the available financial information, the prospect for future earnings of each company and consideration of the Company’s intent and ability to hold the securities until market values recovered, it was determined that the securities in an accumulated loss position in the portfolio were temporary impairments.

For the six months ended June 30, 2013, the Company realized no additional other-than-temporary impairments. The single largest accumulated loss not realized as an impairment was in the equity portfolio and totaled $429,000. The second largest loss position was in the bond portfolio and totaled $56,000. The third largest loss position was in the bond portfolio and totaled $52,000.

For the year ended December 31, 2012, the Company realized $87,000 in other-than-temporary impairments. The single largest accumulated loss not realized as an impairment was in the equity portfolio and totaled $457,000. The second largest loss position was in the bond portfolio and totaled $39,000. The third largest loss position was in the bond portfolio and totaled $27,000.

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Major categories of investment income are summarized as follows (dollars in thousands):

	Three months ended June 30,		Six months ended June 30,	
	2013	2012	2013	2012
Fixed maturities	$815	$879	$1,640	$1,762
Equity securities	45	54	73	112
Mortgage loans on real estate	6	8	13	13
Investment real estate	41	11	81	22
Policy loans	26	21	50	46
Company owned life insurance change in surrender value	(198)	54	(148)	171
Other, principally short-term investments	50	89	208	177
	785	1,116	1,917	2,303
Less: Investment expenses	57	50	105	102
Net investment income	$728	$1,066	$1,812	$2,201

Major categories of investment gains and losses are summarized as follows (dollars in thousands):

	Three months ended June 30,		Six months ended June 30,	
	2013	2012	2013	2012
Fixed maturities	$102	$55	$127	$128
Equity securities	928	734	928	734
Trading securities	—	—	—	2
Other, principally real estate	—	76	2	207
Other-than-temporary impairments	—	—	—	—
Net realized investment gains	$1,030	$865	$1,057	$1,071

An analysis of the net change in unrealized appreciation on available-for-sale securities follows (dollars in thousands):

	June 30, 2013 (UNAUDITED)	December 31, 2012
Net change in unrealized appreciation on available-for-sale securities before deferred tax	$(2,963)	$(153)
Deferred income tax	1,007	52
Net change in unrealized appreciation on available-for-sale securities	$(1,956)	$(101)

NOTE 4 – FAIR VALUE OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES

Our available-for-sale securities consists of fixed maturity and equity securities which are recorded at fair value in the accompanying consolidated balance sheets. The change in the fair value of these investments, unless deemed to be other-than-temporarily impaired, is recorded as a component of other comprehensive income.

We are permitted to elect to measure financial instruments and certain other items at fair value, with the change in fair value recorded in earnings. We elected not to measure any eligible items using the fair value option.

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Accounting standards define fair value as the price that would be received to sell an asset or would be paid to transfer a liability in an orderly transaction between market participants at the measurement date, and establishes a framework to make the measurement of fair value more consistent and comparable. In determining fair value, we primarily use prices and other relevant information generated by market transactions involving identical or comparable assets.

The Company categorizes assets and liabilities carried at their fair value based upon a fair value hierarchy:

Level 1 – Quoted prices in active markets for identical assets or liabilities that the Company has the ability to access at the measurement date.

Level 1 assets and liabilities consist of money market fund deposits and certain of our marketable debt and equity instruments, including equity instruments offsetting deferred compensation, that are traded in an active market with sufficient volume and frequency of transactions.

Level 2 - Observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets with insufficient volume or infrequent transactions (less active markets); or model-derived valuations in which all significant inputs are observable or can be derived principally from or corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 2 assets include certain of our marketable debt and equity instruments with quoted market prices that are traded in less active markets or priced using a quoted market price for similar instruments. Level 2 assets also include marketable equity instruments with security-specific restrictions that would transfer to the buyer, marketable debt instruments priced using indicator prices which represent non-binding market consensus prices that can be corroborated by observable market quotes, as well as derivative contracts and debt instruments priced using inputs that are observable in the market or can be derived principally from or corroborated by observable market data. Marketable debt instruments in this category generally include commercial paper, bank time deposits, repurchase agreements for fixed-income instruments, and a majority of floating-rate notes, corporate bonds, and municipal bonds.

Level 3 - Unobservable inputs to the valuation methodology that are significant to the measurement of fair value of assets or liabilities.

Level 3 assets and liabilities include marketable debt instruments, non-marketable equity investments, derivative contracts, and company issued debt whose values are determined using inputs that are both unobservable and significant to the values of the instruments being measured. Level 3 assets also include marketable debt instruments that are priced using indicator prices that we were unable to corroborate with observable market quotes.

Marketable debt instruments in this category generally include asset-backed securities and certain of our floating-rate notes, corporate bonds, and municipal bonds.

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Assets/Liabilities Measured at Fair Value on a Recurring Basis

Financial assets and liabilities measured at fair value on a recurring basis as of June 30, 2013 are summarized in the following table by the type of inputs applicable to the fair value measurements (unaudited) (in thousands):

	Fair Value Measurements at Reporting Date Using			
Description	Total	Level 1	Level 2	Level 3
Financial Assets				
Fixed maturities available-for-sale				
Corporate debt securities	$35,568	$—	$35,568	$—
Trust preferred securities	544	—	544	—
Mortgage backed securities	8,541	—	8,541	—
Private label mortgage backed securities	6,376	—	6,376	—
Obligations of states and political subdivisions	17,522	—	17,522	—
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	7,809	7,809	—	—
Trading securities	19	19	—	—
Equity securities available-for-sale	4,275	3,418	—	857
Total Financial Assets	$80,654	$11,246	$68,551	$857
Financial Liabilities				
Interest rate swap	$984	$—	$—	$984
Total Financial Liabilities	$984	$—	$—	$984

The methods and assumptions the Company uses to estimate the fair value of assets and liabilities measured at fair value on a recurring basis are summarized below.

Fixed maturities available-for-sale — The fair values of the Company’s public fixed maturity securities are generally based on prices obtained from independent pricing services. Consistent with the fair value hierarchy described above, securities with validated quotes from pricing services are generally reflected within Level 2, as they are primarily based on observable pricing for similar assets and/or other market observable inputs.

Trading securities — Trading securities consist primarily of mutual funds whose fair values are determined consistent with similar instruments described above under “Fixed Maturities” and below under “Equity Securities.”

Equity securities — Equity securities consist principally of investments in common and preferred stock of publicly traded companies and privately traded securities. The fair values of our publicly traded equity securities are based on quoted market prices in active markets for identical assets and are classified within Level 1 in the fair value hierarchy. Estimated fair values for our privately traded equity securities require a substantial level of judgment. Privately traded equity securities are classified within Level 3.

Interest rate swaps — Interest rate swaps are recorded at fair value either as assets, within other assets or as liabilities, within other liabilities. The fair values of our interest rate swaps are provided by a third party broker and are classified within Level 3.

As of June 30, 2013, Level 3 fair value measurements of assets include $857,000 of equity securities in a local community bank whose value is based on an evaluation of the financial statements of the entity. The Company does not develop the unobservable inputs used in measuring fair value.

As of June 30, 2013, Level 3 fair value measurements of liabilities include $984,000 net fair value of various interest rate swap agreements whose value is based on analysis provided by a third party broker. The Company does not

develop the unobservable inputs used in measuring fair value. Additional information regarding the interest rate swap agreements is provided in Note 7.

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The table below presents a reconciliation for all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the six months ended June 30, 2013 (in thousands):

For the six months ended June 30, 2013 (unaudited)	Equity Securities Available-for-Sale	Interest Rate Swap
Beginning balance	$829	$(1,521)
Total gains or losses (realized and unrealized):		
Included in earnings	—	—
Included in other comprehensive income	28	537
Purchases:	—	—
Sales:	—	—
Issuances:	—	—
Settlements:	—	—
Transfers in/(out) of Level 3	—	—
Ending balance	$857	$(984)
The amount of total gains or losses for the period included in earnings attributable to the change in unrealized gains or losses relating to assets and liabilities still held as of June 30, 2013:	$—	$—

For the six months ended June 30, 2013, there were no assets or liabilities measured at fair values on a nonrecurring basis.

Financial assets and liabilities measured at fair value on a recurring basis as of December 31, 2012 are summarized in the following table by the type of inputs applicable to the fair value measurements (in thousands):

	Fair Value Measurements at Reporting Date Using			
Description	Total	Level 1	Level 2	Level 3
Financial Assets				
Fixed maturities available-for-sale				
Corporate debt securities	$33,737	$—	$33,737	$—
Trust preferred securities	587	—	587	—
Mortgage backed securities	8,685	—	8,685	—
Private label mortgage backed securities	7,964	—	7,964	—
Obligations of states and political subdivisions	17,516	—	17,516	—
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	7,805	7,805	—	—
Trading securities	40	40	—	—
Equity securities available-for-sale	5,132	4,303	—	829
Total Financial Assets	$81,466	$12,148	$68,489	$829
Financial Liabilities				
Interest rate swap	$1,521	$—	$—	$1,521
Total Financial Liabilities	$1,521	$—	$—	$1,521

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The table below presents a reconciliation for all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the year ended December 31, 2012 (in thousands):

For the year ended December 31, 2012	Equity Securities Available-for-Sale	Interest Rate Swap
Beginning balance	$642	$(1,196)
Total gains or losses (realized and unrealized):		
Included in earnings	—	—
Included in other comprehensive income	44	(325)
Purchases:	143	—
Sales:	—	—
Issuances:	—	—
Settlements:	—	—
Transfers in/(out) of Level 3	—	—
Ending balance	$829	$(1,521)
The amount of total gains or losses for the period included in earnings attributable to the change in unrealized gains or losses relating to assets and liabilities still held as of December 31, 2012:	$—	$—

For the year ended December 31, 2012, there were no assets or liabilities measured at fair values on a nonrecurring basis.

The Company is exposed to certain risks in the normal course of its business operations. The primary risk that is managed through the use of derivatives is interest rate risk on floating rate borrowings. This risk is managed through the use of interest rate swap agreements which are designated as cash flow hedges. For cash flow hedges, the effective portion of the gain or loss on the interest rate swap is included as a component of other comprehensive income and reclassified into earnings in the same period during which the hedged transaction is recognized in earnings. The Company does not hold or issue derivatives that are not designated as hedging instruments. See Note 7 for additional information about the interest rate swap agreements.

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

Cash and cash equivalents — the carrying amount is a reasonable estimate of fair value.

Mortgage loans — the carrying amount is a reasonable estimate of fair value due to the restrictive nature and limited marketability of the mortgage notes.

Policy loans — the carrying amount is a reasonable estimate of fair value.

Company owned life insurance — the carrying amount is a reasonable estimate of fair value.

Other invested assets — the carrying amount is a reasonable estimate of fair value.

Other policyholder funds — the carrying amount is a reasonable estimate of fair value.

Debt — the carrying amount is a reasonable estimate of fair value.

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The carrying amount and estimate fair value of the Company's financial instruments as of June 30, 2013 and December 31, 2012 are as follows (in thousands):

	June 30, 2013 (UNAUDITED)		December 31, 2012	
	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value
Assets and related instruments				
Mortgage loans	$379	$379	$383	$383
Policy loans	1,359	1,359	1,317	1,317
Company owned life insurance	5,783	5,783	5,931	5,931
Other invested assets	3,650	3,650	3,777	3,777
Liabilities and related instruments				
Other policyholder funds	1,422	1,422	1,417	1,417
Short-term notes payable and current portion of long-term debt	1,367	1,367	1,292	1,292
Long-term debt	25,639	25,639	25,339	25,339

NOTE 5 – PROPERTY AND EQUIPMENT

Major categories of property and equipment are summarized as follows (dollars in thousands):

	June 30, 2013 (UNAUDITED)	December 31, 2012
Building and improvements	$3,185	$3,185
Electronic data processing equipment	1,832	1,814
Furniture and fixtures	904	912
	5,921	5,911
Less accumulated depreciation	3,663	3,519
	$2,258	$2,392

Depreciation expense for the six months ended June 30, 2013 was $201,000 ($433,000 for the year ended December 31, 2012).

NOTE 6 – INCOME TAXES

The Company recognizes tax-related interest and penalties as a component of tax expense. The Company has not incurred any income tax related interest and penalties during the six-month period ended June 30, 2013 and incurred no income tax related interest and penalties during 2012. The Company files income tax returns in the U.S. federal jurisdiction and various states. The Company is not subject to examinations by authorities related to its U.S. federal or state income tax filings for years prior to 2009. Tax returns have been filed through the year 2011. Extensions have been filed for 2012.

Net deferred tax liabilities are determined based on the estimated future tax effects of differences between the financial statement and tax basis of assets and liabilities given the provisions of the enacted tax laws. Management believes that, based on its historical pattern of taxable income, the Company will produce sufficient income in the

future to realize its deferred tax assets. The Company recognized net deferred tax asset positions of $6,465,000 at June 30, 2013 and $4,997,000 at December 31, 2012.

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The tax effect of significant differences representing deferred tax assets and liabilities are as follows (dollars in thousands):

	June 30, 2013 (UNAUDITED)	December 31, 2012
General expenses	$1,293	$1,211
Unearned premiums	1,915	1,751
Claims liabilities	440	243
Litigation settlement	3,570	3,570
AMT credit	246	246
NOL carryforward	2,873	2,711
Other-than-temporary impairments on securities owned	164	164
Unrealized loss on interest rate swaps	335	518
Deferred tax assets	10,836	10,414
Trading securities	—	(1)
Depreciation	(77)	(94)
Deferred policy acquisition costs	(3,074)	(3,093)
Unrealized gains on securities available-for-sale	(1,220)	(2,229)
Deferred tax liabilities	(4,371)	(5,417)
Net deferred tax asset	$6,465	$4,997

The appropriate income tax effects of changes in temporary differences are as follows (dollars in thousands):

	Six months ended June 30,	
	2013 (UNAUDITED)	2012
Deferred policy acquisition costs	$(19)	$49
Other-than-temporary impairments	—	27
Trading securities	(1)	—
Unearned premiums	(164)	(113)
General expenses	(82)	(61)
Depreciation	(17)	(24)
Claim liabilities	(197)	22
Litigation settlement	—	(3,995)
NOL carryforward	(162)	(230)
Deferred income tax benefit	$(642)	$(4,325)

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Total income tax (benefit) expense varies from amounts computed by applying current federal income tax rates to income or loss before income taxes. The reasons for these differences and the approximate tax effects are as follows:

	Six months ended June 30,	
	2013	2012
Federal income tax rate applied to pre-tax income/loss	34.0 %	34.0 %
Dividends received deduction and tax-exempt interest	(48.2)%	0.8 %
Company owned life insurance	37.7 %	0.5 %
Small life deduction	(197.3)%	2.1 %
Life reserve tax adjustment	(147.4)%	— %
Other, net	6.2 %	0.6 %
Effective federal income tax rate	(315.0)%	38.0 %

NOTE 7 – NOTES PAYABLE AND LONG-TERM DEBT

Short-term debt and current portion of long-term debt consisted of the following as of June 30, 2013 and December 31, 2012:

	(Dollars in thousands)	
	2013 (UNAUDITED)	2012
Line of credit with variable interest rate equal to the Wall Street Journal (WSJ) prime rate, subject to a 5.0% floor; maturity January 2014. Interest payments due quarterly. Unsecured.	$200	$125
Current portion of installment note payable due November 2013 with variable interest rate equal to the WSJ prime rate plus 1%; Unsecured	1,167	1,167
	$1,367	$1,292

Long-term debt consisted of the following as of June 30, 2013 and December 31, 2012:

	(Dollars in thousands)	
	2013 (UNAUDITED)	2012
Line of credit with variable interest rate equal to the WSJ prime rate, subject to a 4.5% floor; maturity September 2017. Interest payments due monthly. Secured.	$3,934	$3,634
Long term portion of installment note with variable interest rate equal to the WSJ prime rate plus 1% and adjustable each November; maturity November 2021. Interest payable annually with principal payable in equal annual installments. Next principal installment on long term portion due November 2014. Unsecured.	9,333	9,333
Subordinated debentures issued on December 15, 2005 with fixed interest rate of 8.83% each distribution period thereafter until December 15, 2015 when the coupon rate shall equal the 3-Month LIBOR plus 3.75% applied to the outstanding principal; maturity December 2035. Interest payments due quarterly. All may be redeemed at any time following the tenth anniversary of issuance. Unsecured.	9,279	9,279

Subordinated debentures issued on June 21, 2007 with a floating interest rate equal to the 3-Month LIBOR plus 3.40% applied to the outstanding principal; maturity June 15, 2037. Interest payments due quarterly. All may be redeemed at any time following the fifth anniversary of issuance. Unsecured.	3,093	3,093
	$25,639	$25,339

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The subordinated debentures (debentures) have the same maturities and other applicable terms and features as the associated trust preferred securities (TPS). Payment of interest may be deferred for up to 20 consecutive quarters; however, stockholder dividends cannot be paid during any extended interest payment period or any time the debentures are in default. All have stated maturities of thirty years. None of the TPS securities require the Company to maintain minimum financial covenants. The Company has guaranteed that amounts paid to the Trusts will be remitted to the holders of the associated TPS. This guarantee, when taken together with the obligations of the Company under the debentures, the Indentures pursuant to which the debentures were issued, and the related trust agreement (including obligations to pay related trust fees, expenses, debt and other obligations with respect to the TPS), provides a full and unconditional guarantee of amounts due the Trusts. The amount guaranteed is not expected to at any time exceed the obligations of the TPS, and no additional liability has been recorded related to the guarantee.

The Company has entered into various swap agreements related to the trust preferred securities. On March 19, 2009, the Company entered into a forward swap effective September 17, 2012, with a notional amount of $3,000,000 and designated the swap as a hedge against changes in cash flows attributable to changes in the benchmark interest rate (LIBOR) associated with the subordinated debentures issued June 21, 2007. Commencing September 17, 2012, under the terms of the forward swap, the Company receives interest at the three-month LIBOR rate plus 3.4% and pay interest at the fixed rate of 7.02%. This forward swap will effectively fix the interest rate on $3,000,000 in debt until September of 2019.

On May 26, 2010, the Company entered into a forward swap with a notional amount of $9,000,000 effective December 15, 2015, which will hedge against changes in cash flows following the termination of the fixed rate period. Quarterly, commencing March 16, 2016 under the terms of the forward swap, the Company will pay interest at a fixed rate of 8.49% until March 15, 2020.

The swaps entered into in 2009 and 2010 have fair values of $317,000 (liability) and $667,000 (liability), respectively, for a total liability of $984,000 at June 30, 2013 ($1,521,000 at December 31, 2012). The swap liability is reported as a component of other liabilities on the condensed consolidated balance sheets. A net valuation gain of $354,000 is included in accumulated other comprehensive income related to the swap agreements for the current period. A net valuation loss of $214,000 was included in accumulated other comprehensive income related to the swap at December 31, 2012.

We use dollar offset at the hedge's inception and for each reporting period thereafter to assess whether the derivative used in a hedging transaction is expected to be, and has been, effective in offsetting changes in the fair value of the hedged item. Since inception, no portion of the hedged item has been deemed ineffective. For all hedges, we discontinue hedge accounting if it is determined that a derivative is not expected to be, or has ceased to be, effective as a hedge.

The Company’s interest rate swaps include provisions requiring the Company to post collateral when the derivative is in a net liability position. The Company has securities on deposit with fair market values of $1,474,000 (all of which is posted as collateral). At December 31, 2012, the Company had securities on deposit with fair market values of $1,557,000, all of which is posted as collateral. See Note 4 for additional information about the interest rate swaps.

In January 2013, the Company renewed an unsecured line of credit for $700,000, with an interest rate of 5%, to be made available for general corporate purposes. As of June 30, 2013, $200,000 was drawn on this line ($125,000 at December 31, 2012).

In July 2012, the Company executed a promissory note in the amount of $13,000,000 payable to the Bagley Family Revocable Trust with an interest rate of WSJ prime plus 1% (4.25% at June 30, 2013 and December 31, 2012). The purpose of this promissory note is to finance the settlement obligation related to the Mobile Attic litigation. As of June 30, 2013 and December 31, 2012, a total of $10,500,000 was outstanding with principal payments due in equal annual installments of $1,167,000 payable each November beginning in 2013. Installment payments due within 12 months of the balance sheet date are classified as current portion of long term debt. The promissory note allows for the Company to defer payments in years in which its P&C subsidiaries incur substantial catastrophe losses thus allowing capital management flexibility in the P&C subsidiaries. Under the terms of the promissory note, annual debt service payments on the note must equal or exceed any payment of dividends to shareholders in the preceding twelve months.

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In September 2012, the Company obtained a secured line of credit in the amount of $4,000,000 with an interest rate equal to the WSJ prime (4.5% at December 31, 2012) and subject to a 4.5% floor. As of June 30, 2013, $3,934,000 was drawn on this line ($3,634,000 at December 31, 2012) . The line of credit is secured by timber property investments of the Company.

NOTE 8 – REINSURANCE

The Company's insurance operations utilize reinsurance in order to limit losses, minimize exposure to large risks, provide additional capacity for future growth and effect business-sharing arrangements. Life reinsurance is accomplished through yearly renewable term coverage. Property and casualty reinsurance is placed on both a quota-share and excess of loss basis. Reinsurance ceded arrangements do not discharge the insurance subsidiaries as the primary insurer, except for cases involving a novation. Failure of re-insurers to honor their obligations could result in losses to the insurance subsidiaries. The insurance subsidiaries evaluate the financial conditions of their reinsurance companies and monitor concentrations of credit risk arising from similar geographic regions, activities, or economic characteristics of the companies to minimize their exposure to significant losses from reinsurance insolvencies.

In the normal course of business, NSFC seeks to reduce the loss that may arise from catastrophes or other individually significant large loss events that cause unfavorable underwriting results by re-insuring certain levels of risk in various areas of exposure with reinsurance companies. NSFC maintains a catastrophe reinsurance agreement to cover losses from catastrophic events, primarily hurricanes.

Under the catastrophe reinsurance program, the Company retains the first $4,000,000 in losses from each catastrophe event. Reinsurance coverage is maintained in four layers as follows:

Layer	Reinsurers' Limits of Liability
First Layer	100% of $6,000,000 in excess of $4,000,000
Second Layer	100% of $7,500,000 in excess of $10,000,000
Third Layer	100% of $25,000,000 in excess of $17,500,000
Fourth Layer	100% of $30,000,000 in excess of $42,500,000

Each reinsurance layer covers events occurring from January 1-December 31 of the contract year. All significant reinsurance companies under the program carry A.M. Best ratings of A- (Excellent) or higher, or equivalent ratings.

The Company's catastrophe reinsurance contract allows for one reinstatement. The Company maintains reinstatement premium protection (RPP) to cover reinstatement premiums incurred. The RPP further reduces risk from a major catastrophe and serves to strengthen the Company's capital position by reducing the modeled 100 year event net cost.

Amounts recoverable from re-insurers are estimated in a manner consistent with the claim liability associated with the underlying insurance policies. Amounts paid for prospective reinsurance contracts are reported as prepaid reinsurance premiums and amortized over the remaining contract period.

In the normal course of business, NSIC seeks to limit its exposure to loss on any single insured and to recover a portion of benefits paid by ceding reinsurance to reinsurance companies under excess coverage contracts. NSIC retains a maximum of $50,000 of coverage per individual life. The cost of reinsurance is amortized over the contract

period of the reinsurance.

At June 30, 2013, the largest reinsurance recoverable of a single reinsurer was $133,000 ($295,000 at December 31, 2012). Amounts reported as ceded incurred losses in both 2013 and 2012 were related to the development of losses from prior year catastrophes.

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The effect of reinsurance on premiums written and earned in the property and casualty segment is as follows (dollars in thousands):

	Three months ended June 30, 2013		Three months ended June 30, 2012	
	Written	Earned	Written	Earned
Direct	$15,619	$13,568	$15,325	$13,210
Assumed	—	—	—	—
Ceded	(2,188)	(2,192)	(2,416)	(2,396)
Net	$13,431	$11,376	$12,909	$10,814

	Six months ended June 30, 2013		Six months ended June 30, 2012	
	Written	Earned	Written	Earned
Direct	$29,099	$26,895	$28,291	$26,617
Assumed	—	—	—	—
Ceded	(4,320)	(4,331)	(4,071)	(4,059)
Net	$24,779	$22,564	$24,220	$22,558

The effect of reinsurance on premiums written and earned in the life segment is as follows (dollars in thousands):

	Three months ended June 30, 2013		Three months ended June 30, 2012	
	Written	Earned	Written	Earned
Direct	$1,621	$1,673	$1,718	$1,734
Assumed	—	—	—	—
Ceded	(11)	(11)	(15)	(15)
Net	$1,610	$1,662	$1,703	$1,719

	Six months ended June 30, 2013		Six months ended June 30, 2012	
	Written	Earned	Written	Earned
Direct	$3,283	$3,438	$3,412	$3,506
Assumed	—	—	—	—
Ceded	(30)	(30)	(35)	(35)
Net	$3,253	$3,408	$3,377	$3,471

NOTE 9 – EMPLOYEE BENEFIT PLANS

The Company and its subsidiaries have an established retirement savings plan (401K Plan). All full-time employees are eligible to participate, and all employer contributions are fully vested for employees who have completed 1,000 hours of service in the year of contribution. Company matching contributions for the three months ended June 30, 2013 and 2012 amounted to $49,000 and $52,000, respectively. Company matching contributions for the six months ended June 30, 2013 and 2012 amounted to $97,000 and $102,000, respectively. The Company contributes dollar-for-dollar matching contributions up to 5% of compensation subject to government limitations.

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In January 2006, the Company established a non-qualified plan under which directors are allowed to defer all or a portion of directors' fees into various investment options.

The supplemental executive retirement plan (SERP) became effective March 1, 2008 and covers named executive officers with the Company contributing 15% of executive compensation to the plan. Contributions to the plan are fully vested upon the earlier of death, disability, change in control, or ten years of participation in the plan. Costs for amounts credited of the non-qualified deferred compensation plans for the three months ended June 30, 2013 and 2012 amounted to approximately $37,000 and $4,000, respectively. Costs for amounts credited of the non-qualified deferred compensation plans for the six months ended June 30, 2013 and 2012 amounted to approximately $113,000 and $87,000, respectively.

The Company and its subsidiaries established an Employee Stock Ownership Plan (ESOP) in January 2010, to enable its eligible employees to acquire a proprietary interest in the Company's common stock and to provide retirement and other benefits to such employees. The Company incurred $50,000 in costs related to the ESOP during the first six months of 2013. No costs were incurred during the first six months of 2012 related to the ESOP.

NOTE 10 – REGULATORY REQUIREMENTS AND DIVIDEND RESTRICTIONS

The Company is dependent on dividends from its insurance subsidiaries to fund operations and payment of shareholder dividends. Dividend payments from the insurance subsidiaries are subject to regulatory review/approval and statutory limitations. The statutory limitations are outlined as follows:

The amount of dividends paid from NSIC to the Company in any year may not exceed, without prior approval of regulatory authorities, the greater of 10% of statutory surplus as of the end of the preceding year, or the statutory net gain from operations for the preceding year. At December 31, 2012, NSIC's retained earnings unrestricted for the payment of dividends in the next twelve months amounted to $1,034,000.

NSFC is similarly restricted in the amount of dividends payable to the Company; dividends may not exceed the greater of 10% of statutory surplus as of the end of the preceding year, or net income for the preceding year. At December 31, 2012, NSFC's retained earnings unrestricted for the payment of dividends in the next twelve months amounted to $2,468,000.

The payment of any subsidiary dividend requires prior notice to the regulatory authorities who may disallow the dividend if, in their judgment, payment of the dividend would have an adverse effect on the surplus of the subsidiary.

At June 30, 2013, securities with market values of $3,583,000 ($3,785,000 at December 31, 2012) were deposited with various states pursuant to statutory requirements.

NOTE 11 – SHAREHOLDERS' EQUITY

During the six months ended June 30, 2013, and year ended December 31, 2012, changes in shareholders' equity consisted of a net income of $556,000 and net loss of $6,671,000, respectively; dividends paid of $123,000 in 2013 and $802,000 in 2012; changes in accumulated other comprehensive loss, net of applicable taxes, of $1,602,000 in 2013 and $315,000 in 2012. Other comprehensive loss consists of accumulated unrealized gains and losses on securities and unrealized gains and losses on interest rate swaps.

Preferred Stock

Preferred Stock may be issued in one or more series as shall from time to time be determined and authorized by the Board of Directors. The directors may make specific provisions regarding (a) the voting rights, if any (b) whether such dividends are to be cumulative or noncumulative (c) the redemption provisions, if any (d) participating rights, if any (e) any sinking fund or other retirement provisions (f) dividend rates (g) the number of shares of such series and (h) liquidation preference.

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Common Stock
The holders of the Class A Common Stock will have one-twentieth of one vote per share, and the holders of the common stock will have one vote per share. There is currently no Class A Common Stock issued or outstanding.

In the event of any liquidation, dissolution or distribution of the assets of the Company remaining after the payments to the holders of the Preferred Stock of the full preferential amounts to which they may be entitled as provided in the resolution or resolutions creating any series thereof, the remaining assets of the Company shall be divided and distributed among the holders of both classes of common stock, except as may otherwise be provided in any such resolution or resolutions.

The table below provides information regarding the Company's preferred and common stock as of June 30, 2013 and December 31, 2012:

	June 30, 2013			December 31, 2012		
	Authorized	Issued	Outstanding	Authorized	Issued	Outstanding
Preferred Stock, $1 par value	500,000	—	—	500,000	—	—
Class A Common Stock, $1 par value	2,000,000	—	—	2,000,000	—	—
Common Stock, $1 par value	3,000,000	2,494,480	2,494,480	3,000,000	2,466,600	2,466,600

On June 28, 2013, 27,880 shares of common stock were issued to directors as compensation under the 2009 Equity Incentive Plan previously approved by shareholders.

NOTE 12 – ACCUMULATED OTHER COMPREHENSIVE INCOME

The balance of and changes in each component of accumulated other comprehensive income (loss) ("AOCI") for the six months ended June 30, 2013, net of income taxes, are as follows (dollars in thousands):

	Gains and Losses on Cash Flow Hedges	Unrealized Gains and Losses on Available-for-Sale Securities	Total
Beginning balance	$(1,003)	$4,328	$3,325
Other comprehensive income before reclassifications	354	(1,597)	(1,243)
Amounts reclassified from accumulated other comprehensive income	—	(359)	(359)
Net current period other comprehensive income	354	(1,956)	(1,602)
Ending balance	$(649)	$2,372	$1,723

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The following table presents the amounts reclassified out of AOCI for the six months ended June 30, 2013 (dollars in thousands):

Details about Accumulated Other Comprehensive Income Components	Amounts Reclassified from Accumulated Other Comprehensive Income	Affected Line Item in the Statement Where Net Income is Presented
Unrealized Gains and Losses on Available-for-Sale Securities	$ 1,057	Net realized investment gains
	1,057	Total before tax

	C	1,808,881	523,756	(1,285,125)	Ca / CC	50 / 8	
Pre TSL XVII	C	997,495	262,918	(734,577)	Ca / CC	51 / 8	81,960
Pre TSL XVIII	C	999,718	293,417	(706,301)	Ca / CCC	69 / 14	134,031
Pre TSL XIX	C	2,527,613	798,130	(1,729,483)	Ca / CC	60 / 14	103,000
Pre TSL XXIV	B-1	2,190,737	681,711	(1,509,026)	Caa3 / BB	80 / 13	299,300
Pre TSL XXV	C-1	506,673	78,441	(428,232)	Ca / C	64 / 9	264,100
Pre TSL XXVII	B	2,369,969	1,043,561	(1,326,408)	B3 / BB	42 / 7	65,300
		$ 19,299,725	$ 7,838,588	$ (11,461,137)			

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

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

For a further discussion on the fair value determination of the Company's investment in pooled trust preferred securities, see "Investment securities" under the caption "Comparison of financial condition at September 30, 2009 and December 31, 2008" of Part 1, Item 2, "Management's Discussion and Analysis of Financial Condition and Results of Operations"; below.

4. Earnings (loss) per share

Basic earnings (loss) per share (EPS) is computed by dividing income (loss) available to common shareholders by the weighted-average number of common stock outstanding for the period. Diluted EPS is computed in the same manner as basic EPS but reflects the potential dilution that could occur if stock options to issue additional common stock were exercised, which would then result in additional stock outstanding to share in or dilute the earnings (loss) of the Company. The Company maintains two share-based compensation plans that may generate additional potential dilutive common shares. Generally, dilution would occur if Company-issued stock options were exercised and converted into common stock. There were no potentially dilutive shares outstanding at September 30, 2009 and 85 potentially dilutive shares outstanding at September 30, 2008.

In the computation of diluted EPS, the Company uses the treasury stock method to determine the dilutive effect of its granted but unexercised stock options. Under the treasury stock method, the assumed proceeds received from shares issued, in a hypothetical stock option exercise, are assumed to be used to purchase treasury stock. There were no potentially dilutive shares outstanding as of September 30, 2009 because the average share price of the Company's common stock during the nine months ended September 30, 2009 was below the strike prices of all options granted. For a further discussion on the Company's stock option plans, see note 5, "Stock plans," below.

The following table illustrates the data used in computing basic EPS and a reconciliation to derive at the components of diluted EPS for the periods indicated:

Nine months ended September 30,		2009		2008
Net income (loss) available to common shareholders	$	(1,473,469)	$	3,034,008
Weighted-average common shares outstanding		2,075,181		2,071,242
Basic EPS	$	(0.71)	$	1.46
Diluted EPS:				
Net income (loss) available to common shareholders	$	(1,473,469)	$	3,034,008
Weighted-average common shares outstanding		2,075,181		2,071,242
Potentially dilutive common shares		-		85
Weighted-average common shares and dilutive potential shares		2,075,181		2,071,327
Diluted EPS	$	(0.71)	$	1.46

5. Stock plans

The Company has two stock-based compensation plans (the stock option plans) and applies the fair value method of accounting for stock-based compensation provided under the guidelines of FASB ASC 718-10, Share Based Payment. The guidelines require the cost of share-based payment transactions (including those with employees and non-employees) be recognized in the financial statements.

Under the stock option plans, options are granted with an exercise price equal to the market price of the Company's stock on the date of grant. The awards vest based on six months of continuous service from the date of grant and have 10-year contractual terms. Stock-based compensation expense is recognized over the six-month vesting

period. Generally, all shares that are granted become fully vested. Stock-based compensation is recorded in the consolidated income statement as a component of salaries and employee benefits.

The Company established the 2000 Independent Directors Stock Option Plan and has reserved 55,000 shares of its un-issued capital stock for issuance under the plan. No stock options were awarded during the nine months ended September 30, 2009 and 2008. As of September 30, 2009, there were 27,400 unexercised stock options outstanding under this plan.

The Company also established the 2000 Stock Incentive Plan and has reserved 55,000 shares of its un-issued capital stock for issuance under the plan. There were no options awarded during the nine months ended September 30, 2009. During the nine months ended September 30, 2008, 2,000 stock options were issued under this plan at a weighted-average grant-date fair value of $4.85 per share. The Company uses the Black-Scholes Option Pricing Valuation Model to determine the fair value of awarded options on the date of grant. The model considers expected volatility, expected dividends, risk-free interest rate and the expected term. As of September 30, 2009, there were 10,190 unexercised stock options outstanding under this plan.

The following tables illustrate stock-based compensation expense recognized during the three- and nine months ended September 30, 2009 and 2008. There was no unrecognized stock-based compensation expense as of September 30, 2009, September 30, 2008 and December 31, 2008:

	Three months ended September 30,		Nine months ended September 30,	
	2009	2008	2009	2008
Stock-based compensation expense:				
Director's Plan	$ -	$ -	$ -	$ 90,550
Incentive Plan	-	2,314	-	35,562
Total stock-based compensation expense	$ -	$ 2,314	$ -	$ 126,112

In addition to the two stock option plans, the Company established the 2002 Employee Stock Purchase Plan (the ESPP) and reserved 110,000 shares of its un-issued capital stock for issuance under the plan. The plan was designed to promote broad-based employee ownership of the Company’s stock. Under the ESPP, employees may elect to purchase the Company’s capital stock at a discounted price based on the fair market value of the Company’s capital stock on either the commencement date or termination date. At September 30, 2009, 12,271 shares have been issued under the ESPP. Under the guidelines required by share based payments, the Company recognizes compensation expense on its ESPP on the date the shares are purchased. For the nine months ended September 30, 2009 and 2008, compensation expense related to the ESPP approximated $5,000 and $3,000, respectively, and is included as components of salaries and employee benefits in the consolidated statements of income.

6. Derivative instruments

As part of its overall interest rate risk management strategy, the Company has adopted a policy whereby it may periodically use derivative instruments to minimize significant fluctuations in earnings caused by interest rate volatility. This interest rate risk management strategy entails the use of interest rate floors, caps and swaps. During the fourth quarter of 2006, the Company entered into a three-year interest rate floor derivative agreement on $20,000,000 notional value of its prime-based loan portfolio. The transaction required the payment of a premium by the Company to the seller for the right to receive payments in the event national prime drops below a pre-determined level (strike rate), essentially converting floating rate loans to fixed rate loans when prime drops below the contractual strike rate. When purchased, the Company recorded an asset representing the fair value of the hedge at the time of purchase. The Company has designated this agreement as a cash flow hedge pursuant to the implementation of FASB ASC 815-20, Accounting for Derivative Instruments and Hedging Activities. Accordingly, the change in the fair value of the instrument related to the hedge’s intrinsic value, or approximately ($561,000) and $96,000 for the nine months ended September 30, 2009 and 2008, respectively, is recorded as a component of other comprehensive income (loss) (OCI) in the consolidated statement of changes in shareholders’ equity and the portion of the change in fair value related to the time value expiration, or approximately $2,000 and $12,000 for the nine months ended September 30, 2009 and 2008, respectively, is recorded in the consolidated statements of income as a reduction of interest income. No gain or loss has been recognized in earnings due to hedge ineffectiveness as of September 30, 2009. Also, as of September 30, 2009 and December 31, 2008, the fair value of the derivative contract approximated $73,000 and $636,000, respectively, and is recorded as a component of other assets in the consolidated balance sheets. As of September 30, 2009, the Company expects to close out the residual net value of the derivative, or approximately $29,000, from other assets and OCI to earnings during the fourth quarter in concert with the contract’s expiration date. The following table illustrates the present value, intrinsic value and time value components of the Company’s derivative contract and the financial statement impact of the change in the fair value for the periods indicated:

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	Nine months ended or as of September 30,		
	Present value Balance sheet Other assets	Intrinsic value Balance sheet OCI	Time value Income statement Interest income
2009			
Beginning Balance	$ 635,839	$ 606,492	
Change in fair value	(562,499)	(560,956)	(1,543)
Balance September 30, 2009	$ 73,340	$ 45,536	
2008			
Beginning Balance	$ 440,593	$ 385,741	
Change in fair value	84,402	96,383	(11,981)
Balance September 30, 2008	$ 524,995	$ 482,124	

As a result of the low national prime rate relative to the contract's strike rate, the Company earned $683,000 and $353,000 for the nine months ended September 30, 2009 and 2008, respectively and $230,000 and $141,000 for the three months ended September 30, 2009 and 2008, respectively, and is included as a component of interest income from loans in the consolidated income statements. The contract expired early in the fourth quarter of 2009.

The use of derivative instruments exposes the Company to credit risk in the event of non-performance by the agreement's counterparty to the derivative instrument. In the event of default by the counterparty, the Company would have been subject to an economic loss that corresponded to the cost to replace the agreement. The Company controlled the credit risk associated with the derivative instrument by engaging counterparties with high credit ratings, establishing counterparty exposure limits and monitoring procedures.

7. Fair value measurements

On April 9, 2009, the FASB issued ASC 820-10-35, Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly, and FASB ASC 825-10-65, Interim Disclosures about Fair Value of Financial Instruments. The Company adopted the guidance under these topics in the second quarter of 2009.

This topic provides guidance on estimating fair value when the volume and level of activity for an asset or liability have significantly decreased in relation to normal market activity. The requirements of fair value measurement also call for additional disclosures on fair value measurements and provide additional guidance on circumstances that may indicate that a transaction is not orderly.

On January 1, 2008, the Company adopted FASB ASC 820-10, Fair Value Measurements which defines fair value, establishes a framework for measuring fair value and enhances disclosures about fair value measurements. The guidelines of fair value reporting establishes a valuation hierarchy for disclosure of the inputs used to measure fair value. This hierarchy prioritizes the inputs into three broad levels as follows:

Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities;

Level 2 inputs are quoted prices for similar assets and liabilities in active markets; quoted prices for identical or similar assets or liabilities in markets that are not active; or inputs that are observable for the asset or liability, either directly or indirectly through market corroboration, for substantially the full term of the financial instrument;

Level 3 inputs are unobservable inputs based on our own assumptions to measure assets and liabilities at fair value. Level 3 pricing for securities may also include unobservable inputs based upon broker-traded transactions. A financial asset or liability's classification within the hierarchy is determined based on the lowest level input that is significant to the fair value measurement.

Adoption of the requirements of the fair value measurement under generally accepted account principles did not have an impact on the Company's financial statements.

The Company uses fair value to measure certain assets and, if necessary, liabilities on a recurring basis when fair value is the primary measure for accounting. This is done for AFS securities, loans AFS and derivatives. Fair value is used on a non-recurring basis to measure certain assets when adjusting carrying values to market values, such as impaired loans.

The following table illustrates the financial instruments measured at fair value on a recurring basis segregated by hierarchy fair value levels as of September 30, 2009 and December 31, 2008 (dollars in thousands):

	Total carrying value at September 30, 2009	Fair value measurements at September 30, 2009: Quoted prices in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Assets:				
Available-for-sale securities:				
U.S. government agencies and corporations	$ 34,996	$ -	$ 34,996	$ -
Obligations of states and political subdivisions	29,764	-	29,764	-
Corporate bonds:				
Pooled trust preferred securities	7,839	-	-	7,839
Mortgage-backed securities	9,357	-	9,357	-
Equity securities	446	446	-	-
Total available-for-sale securities:	82,402	446	74,117	7,839
Loans available-for-sale	881	-	881	-
Derivative instrument	73	-	73	-
Total	$ 83,356	$ 446	$ 75,071	$ 7,839

	Total carrying value at December 31, 2008	Fair value measurements at December 31, 2008: Quoted prices in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Assets:				
Available-for-sale securities:				
U.S. government agencies and corporations	$ 43,507	$ -	$ 43,507	$ -
Obligations of states and political subdivisions	17,553	-	17,553	-
Corporate bonds:				
Pooled trust preferred securities	10,260	-	-	10,260
Mortgage-backed securities	11,530	-	11,530	-
Equity securities	428	428	-	-
Total available-for-sale securities:	83,278	428	72,590	10,260
Loans available-for-sale	84	-	84	-
Derivative instrument	636	-	636	-
Total	$ 83,998	$ 428	$ 73,310	$ 10,260

Equity securities in the AFS portfolio are measured at fair value using quoted market prices for identical assets and are classified within Level 1 of the valuation hierarchy. Other than the Company's investment in corporate bonds, consisting of pooled trust preferred securities, all other debt securities in the AFS portfolio are measured at fair value using prices provided by a third-party vendor, who is a provider of financial market data, analytics and related services

to financial institutions. The Company's pooled trust preferred securities include both observable and unobservable inputs to determine fair value and, therefore, are considered Level 3 inputs. For a further discussion on the fair value determination of the Company's investment in pooled trust preferred securities, see "Investment securities" under the caption "Comparison of financial condition at September 30, 2009 and December 31, 2008" of Part 1, Item 2, "Management's Discussion and Analysis of Financial Condition and Results of Operations," below.

Loans AFS are measured for fair value from quotes received through secondary market sources, i.e., FNMA or FHLB, who provide pricing for similar assets with similar terms in actively traded markets. In the above table, loans AFS reflect the carrying value which is the lower of cost or market value. The derivative instrument, included in other assets, is measured at fair value from pricing provided by a third party who considers observable interest rates, forward yield curves at commonly quoted intervals and volatility.

The following table illustrates the changes in Level 3 financial instruments, consisting of the Company's investment in pooled trust preferred securities, measured at fair value on a recurring basis for the periods indicated (dollars in thousands):

	As of and for the nine months ended September 30, 2009	As of and for the twelve months ended December 31, 2008
Assets:		
Balance at beginning of period	$ 10,260	$ 16,335
Realized / unrealized gains (losses):		
in earnings	(2,758)	(430)
in comprehensive income (loss)	(306)	(9,958)
Purchases, sales, issuances and settlements, amortization and accretion, net	643	4,313
Balance at end of period	$ 7,839	$ 10,260

The following table illustrates the financial instruments measured at fair value on a non-recurring basis segregated by hierarchy fair value levels as of September 30, 2009 and December 31, 2008 (dollars in thousands):

		Fair value measurements at September 30, 2009 using:		
	Total carrying value at September 30, 2009	Quoted prices in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Assets:				
Impaired loans	$ 3,147	$ 13	$ 2,280	$ 854

		Fair value measurements at December 31, 2008 using:		
	Total carrying value at December 31, 2008	Quoted prices in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Assets:				
Impaired loans	$ 1,942	$ 12	$ 1,136	$ 794

Impaired loans that are collateral dependent are written down to fair value through the establishment of specific reserves. Techniques used to value the collateral that secures the impaired loan include: quoted market prices for identical assets classified as Level 1 inputs; observable inputs, employed by certified appraisers for similar assets classified as Level 2 inputs. In cases where valuation techniques included inputs that are unobservable or are based on estimates and assumptions developed by management, with significant adjustments from the best information available under each circumstance, the asset valuation is classified as Level 3 inputs.

Fair value measurement disclosures are now required for interim periods in addition to the annual disclosures. Accordingly, a summary of the carrying values and estimated fair values of certain financial instruments as required by the guidelines follows as of the periods indicated (dollars in thousands):

	September 30, 2009		December 31, 2008	
	Carrying amount	Estimated fair value	Carrying amount	Estimated fair value
Financial assets:				
Cash and cash equivalents	$ 17,632	$ 17,632	$ 12,771	$ 12,771
Held-to-maturity securities	740	796	910	940
Available-for-sale securities	82,402	82,402	83,278	83,278
FHLB stock	4,781	4,781	4,781	4,781
Loans and leases	420,834	420,839	436,207	438,838
Loans available-for-sale	881	894	84	85
Accrued interest	2,543	2,543	2,443	2,443
Financial liabilities:				
Deposit liabilities	477,258	474,357	433,312	436,011
Short-term borrowings	5,238	5,238	38,130	38,130
Long-term debt	32,000	35,427	52,000	57,230
Accrued interest	1,000	1,000	1,390	1,390
On-balance sheet derivative instrument				
Cash flow hedge	73	73	636	636

The following summarizes the methodology used to determine estimated fair values in the above table:

The carrying value of short-term financial instruments, as listed below, approximates their fair value. These instruments generally have limited credit exposure, no stated or short-term maturities and carry interest rates that approximate market.

- Cash and cash equivalents
- Non-interest bearing deposit accounts
- Savings, NOW and money market accounts
- Short-term borrowings
- Accrued interest

Securities: With the exception of preferred term securities, fair values on the other investment securities are determined by prices provided by a third-party vendor, who is a provider of financial market data, analytics and related services to financial institutions. The fair values of pooled trust preferred securities is determined based on a present value technique (income valuation) as described under the caption “Investment securities” of the comparison of financial condition at September 30, 2009 and December 31, 2008 in Part I, Item II, below.

FHLB stock, or restricted regulatory equity, is carried at cost, which approximates fair value.

Loans and leases: The fair value of all loans is estimated by the net present value of the future expected cash flows discounted at the current offering rates.

Loans available-for-sale: For loans available-for-sale, the fair value is estimated using rates currently offered for similar loans and are obtained from the FNMA or the FHLB.

Certificates of deposit: The fair values of certificate of deposit accounts are based on discounted cash flows using rates which approximate the rates we offer for deposits of similar maturities.

Long-term debt: The fair value is estimated using the rates currently offered for similar borrowings.

Cash flow hedge: The carrying amount of interest rate contracts are based on pricing provided by a third party who considers observable interest rates, forward yield curves at commonly quoted intervals and volatility.

8. Subsequent Events

Pursuant to the requirements for disclosing events after September 30, 2009, reportable events have been evaluated through November 12, 2009, which is the date the financial statements were available to be issued. Through that date, there were no events requiring disclosure.

Item 2: Management's Discussion and Analysis of Financial Condition and Results of Operations

The following is management's discussion and analysis of the significant changes in the consolidated financial condition of the Company as of September 30, 2009 compared to December 31, 2008 and the results of operations for the three- and nine month periods ended September 30, 2009 and 2008. Current performance may not be indicative of future results. This discussion should be read in conjunction with the Company's 2008 Annual Report filed on Form 10-K.

Forward-looking statements

Certain of the matters discussed in this Interim Report on Form 10-Q may constitute forward-looking statements for purposes of the Securities Act of 1933, as amended, and the Securities Exchange Act of 1934, as amended, and as such may involve known and unknown risks, uncertainties and other factors which may cause the actual results, performance or achievements of the Company to be materially different from future results, performance or achievements expressed or implied by such forward-looking statements. The words "expect," "anticipate," "intend," "plan," "believe," "estimate," and similar expressions are intended to identify such forward-looking statements.

The Company's actual results may differ materially from the results anticipated in these forward-looking statements due to a variety of factors, including, without limitation:

- the effects of economic deterioration on current customers, specifically the effect of the economy on loan customers' ability to repay loans;
- the costs and effects of litigation and of unexpected or adverse outcomes in such litigation;
- governmental monetary and fiscal policies, as well as legislative and regulatory changes;
- the effect of changes in accounting policies and practices, as may be adopted by the regulatory agencies, as well as the Financial Accounting Standards Board and other accounting standard setters;
- the risks of changes in interest rates on the level and composition of deposits, loan demand, and the values of loan collateral, securities and interest rate protection agreements, as well as interest rate risks;
- the effects of competition from other commercial banks, thrifts, mortgage banking firms, consumer finance companies, credit unions, securities brokerage firms, insurance companies, money market and other mutual funds and other financial institutions operating in our market area and elsewhere, including institutions operating locally, regionally, nationally and internationally, together with such competitors offering banking products and services by mail, telephone, computer and the internet;
- technological changes;
- acquisitions and integration of acquired businesses;
- the failure of assumptions underlying the establishment of reserves for loan and lease losses and estimations of values of collateral and various financial assets and liabilities;
- volatilities in the securities markets;
- deteriorating economic conditions
- acts of war or terrorism; and
- disruption of credit and equity markets.

Management cautions readers not to place undue reliance on forward-looking statements, which reflect analyses only as of the date of this document. We have no obligation to update any forward-looking statements to reflect events or circumstances after the date of this document.

Readers should review the risk factors described in other documents that we file or furnish, from time to time, with the Securities and Exchange Commission, including Annual Reports to Shareholders, Annual Reports filed on Form 10-K and other current reports filed or furnished on Form 8-K.

General

The Company's principal revenues are derived from interest, dividends and fees earned on its interest-earning assets, which are comprised of loans, securities and other short-term investments. The Company's principal expenses consist of interest paid on its interest-bearing liabilities, which are comprised of deposits, short- and long-term borrowings and operating and general expenses. The Company's profitability depends primarily on its net interest income. Net interest income is the difference between interest income and interest expense. Interest income is generated from yields on interest-earning assets which consist principally of loans and investment securities. Interest expense is incurred from rates paid on interest-bearing liabilities, which consist of deposits and borrowings. Net interest income is dependent upon the interest-rate spread (i.e., the difference between the yields earned on its interest-earning assets and the rates paid on its interest-bearing liabilities) and the relative amounts of interest-earning assets and interest-bearing liabilities. The interest rate spread is significantly impacted by: changes in interest rates and market yield curves and their related impact on cash flows; the composition and characteristics of interest-earning assets and interest-bearing liabilities; differences in the maturity and re-pricing characteristics of assets compared to the maturity and re-pricing characteristics of the liabilities that fund them and by the competition in our marketplace.

The Company's profitability is also affected by the level of its non-interest income and expenses, provision for loan losses and provision for income taxes. Non-interest income consists of service charges on the Bank's loan and deposit products, trust and asset management service fees, increases in the cash surrender value of the bank owned life insurance (BOLI), net gains or losses from sales of loans and securities AFS, net gains or losses from sales of foreclosed properties held-for-sale, write-down to market value of foreclosed properties held-for-sale and from other-than-temporary-impairment (OTTI) charges on investment securities. Non-interest expense consists of compensation and related employee benefit expenses, occupancy, equipment, data processing, advertising, marketing, professional fees, insurance and other operating overhead.

The Company's profitability is significantly affected by general economic and competitive conditions, changes in market interest rates, government policies and actions of regulatory authorities. The Company's loan portfolio is comprised principally of commercial and commercial real estate loans. The properties underlying the Company's mortgages are concentrated in Northeastern Pennsylvania. Credit risk, which represents the possibility of the Company not recovering amounts due from its borrowers, is significantly related to local economic conditions in the areas the properties are located as well as the Company's underwriting standards. Economic conditions affect the market value of the underlying collateral as well as the levels of adequate cash flow and revenue generation from income-producing commercial properties.

Comparison of the results of operations
Three and nine months ended September 30, 2009 and 2008

Overview

The Company recorded a net loss of $3,211,000 for the third quarter of 2009 compared to net income of $741,000 recorded in the same quarter of 2008. Diluted (loss) earnings per share were ($1.55) and $0.35 for each of the respective quarters. For the nine months ended September 30, 2009, net loss was $1,473,000, or ($0.71) per share, compared to net income of $3,034,000, or $1.46 per share, for the nine months ended September 30, 2008. The decrease in earnings was due to an increase in the provision for loan losses of $2,995,000 and $3,595,000, during the quarter and year-to-date periods, respectively, and a decrease in non-interest income from higher levels of non-cash credit-related OTTI charges from the pooled trust preferred securities portfolio of $2,029,000 and $2,355,000, respectively, recorded during the comparative periods. Net interest income declined in both the third quarter and for the nine months ended September 30, 2009 compared to the same periods of 2008. During the third quarter of 2009, the Company paid off two of its $5.0 million FHLB advances and incurred a $0.5 million interest penalty. Non-interest expense increased 9% and 7%, respectively. These items were partially offset by higher gains recognized from mortgage banking services in the form of sales of mortgage loans in the three- and nine- month periods ended September 30, 2009 compared to the same periods of 2008.

Return on average assets (ROA) and return on average shareholders' equity (ROE) were -2.25% and -25.75%, respectively, for the three months ended September 30, 2009 compared to 0.50% and 5.63%, respectively, for the same period in 2008. For the nine months ended September 30, 2009, ROA and ROE were -0.35% and -4.07%, respectively, compared to 0.69% and 7.42% for the same periods in 2008. The decrease in both ROA and ROE is attributable to lower earnings.

Net interest income and interest sensitive assets / liabilities

Net interest income decreased $458,000, or 9%, to $4,421,000 for the third quarter of 2009, from $4,879,000 recorded in the same period of 2008. During the current quarter, the Company paid off $10.0 million of long-term Federal Home Loan Bank (FHLB) advances that were scheduled to mature during the third quarter of 2010 and by doing so incurred approximately $0.5 million of prepayment interest penalties that are included in interest expense. The

paid-off advances carried a weighted-average rate of 6.12% and the deleveraging strategy is immediately accretive to income. Compared to 2008, the Company reduced its average balance of FHLB advances by $20.4 million and short-term overnight borrowings by approximately $23.7 million. The FHLB advances were supplanted by growth in average deposits which were also used to help reduce the Company's dependence on short-term borrowings. In this low interest-rate environment, the Company may explore and execute other deleveraging opportunities that management deems prudent for earnings and capital enhancement. Further contributing to the decline in net interest income was a combination of: a 50 basis point decline in yields from earning-assets, mostly in the commercial loan and investment portfolios partially offset by a 35 basis point decline on interest-bearing liabilities primarily from a decrease in rates paid on deposits.

During the third quarter of 2009, the Company's tax-equivalent margin and spread were 3.43% and 2.95%, respectively, compared to 3.62% and 3.10% during the third quarter of 2008. The reduction in spread was caused by lower yields earned on interest-earning assets as well as the early pay-off of the FHLB advances. The decrease in margin was predominately from lower net interest income.

For the nine months ended September 30, 2009, net interest income declined 3%, or, $383,000 compared to the nine months ended September 30, 2008. Excluding the aforementioned early-pay off of the $10.0 million FHLB advances, there would have been a minor improvement in net interest income. Despite the lower net interest income, the Company's tax-equivalent margin and spread improved to 3.62% and 3.17%, respectively, from 3.57% and 3.01% during the same period of 2008. The improvements were largely from lower balances of interest-bearing liabilities – most notably from lower long- and short-term borrowings and lower rates paid on deposits. In addition, the lower balance of interest-earning assets, due to the sale of lower yielding residential mortgage loans during the first quarter of 2009, contributed to the improvement in margin. Rates paid on deposits declined 93 basis points compared to lower yields from earning-assets of 53 basis points.

The current interest rate environment has remained essentially unchanged throughout 2009; however, it is much different than a year ago. The interest rate environment was considerably lower during the first nine months of 2009 compared to 2008. The lower rates have caused assets to price and re-price at significantly lower levels thereby pressuring earning-yields downward. Increased prepayment activity in asset portfolios, thereby shortening the duration of interest-earning assets as well as increased activity in loan refinancing all contribute to lower portfolio yields. However, the steepness of the curve has enabled the Company to help mitigate the lower yields earned from its asset portfolios. To manage the interest rate margin to acceptable levels, the Company's Asset Liability Management (ALM) team meets regularly to discuss interest rate risk and when deemed necessary adjusts interest rates on deposits and repurchase agreements and when necessary uses lower costing wholesale funding sources. The actions of the ALM team have helped minimize the effect rate changes have had on interest income so that net interest income is not materially and disproportionately impacted during this lower yield environment. During the first quarter of 2009, the Company sold $10.8 million of lower yielding mortgage loans and used the proceeds to pay off one $10.0 million FHLB advance that was scheduled to mature in the second quarter of 2009. Similarly, during the third quarter, the Company paid down an additional $10.0 million in FHLB advances with funds from deposit growth. The third quarter transaction required the payment of penalty interest of approximately $0.5 million, however the weighted-average rate on the advances was 6.12% and this strategy will be immediately accretive to future earnings. The Company's proactive attention to interest rate risk should continue to help contain the Company's net interest margin at acceptable levels.

The table that follows sets forth a comparison of average balance sheet amounts and their corresponding fully tax-equivalent (FTE) interest income and expense and annualized tax-equivalent yield and cost for the periods indicated (dollars in thousands):

	Three months ended:					
	September 30, 2009			September 30, 2008		
	Average balance	Interest	Yield / rate	Average balance	Interest	Yield / rate
Assets						
Interest-earning assets:						
Loans and leases	$ 431,024	$ 6,603	6.08%	$ 426,002	$ 6,953	6.49%
Investments	99,922	1,065	4.23	125,901	1,611	5.09
Federal funds sold	5,335	3	0.25	-	-	-
Interest-bearing deposits	622	-	0.06	104	1	2.33
Total interest-earning assets	536,903	7,671	5.67	552,007	8,565	6.17
Non-interest-earning assets	29,089			32,023		
Total assets	$ 565,992			$ 584,030		
Liabilities and shareholders' equity						
Interest-bearing liabilities:						
Other interest-bearing deposits	$ 228,308	$ 579	1.01%	$ 191,697	$ 799	1.66%
Certificates of deposit	163,683	1,370	3.32	168,730	1,800	4.24
Borrowed funds	42,746	1,077	10.00	86,778	930	4.26
Repurchase agreements	7,266	6	0.32	10,907	11	0.42
Total interest-bearing liabilities	442,003	3,032	2.72	458,112	3,540	3.07
Non-interest-bearing deposits	70,412			69,069		
Other non-interest-bearing liabilities	4,102			4,466		
Shareholders' equity	49,475			52,383		
Total liabilities and shareholders' equity	$ 565,992			$ 584,030		
Net interest income / interest rate spread		$ 4,639	2.95%		$ 5,025	3.10%
Net interest margin			3.43%			3.62%

	Nine months ended:					
	September 30, 2009			September 30, 2008		
	Average balance	Interest	Yield / rate	Average balance	Interest	Yield / rate
Assets						
Interest-earning assets:						
Loans and leases	$ 432,607	$ 19,866	6.14%	$ 414,809	$ 20,785	6.69%
Investments	98,971	3,436	4.64	134,010	5,301	5.28
Federal funds sold	5,872	11	0.25	4,465	91	2.73
Interest-bearing deposits	722	-	0.10	124	2	2.59
Total interest-earning assets	538,172	23,313	5.79	553,408	26,179	6.32
Non-interest-earning assets	29,048			33,830		
Total assets	$ 567,220			$ 587,238		
Liabilities and shareholders' equity						

Interest-bearing liabilities:						
Other interest-bearing deposits	$ 217,674	$ 1,698	1.04%	$ 193,508	$ 2,746	1.90%
Certificates of deposit	169,808	4,581	3.61	179,712	5,918	4.40
Borrowed funds	49,138	2,448	6.66	75,498	2,652	4.69
Repurchase agreements	9,144	22	0.33	12,166	92	1.01
Total interest-bearing liabilities	445,764	8,749	2.62	460,884	11,408	3.31
Non-interest-bearing deposits	69,143			67,062		
Other non-interest-bearing liabilities	3,950			4,642		
Shareholders' equity	48,363			54,650		
Total liabilities and shareholders' equity	$ 567,220			$ 587,238		
Net interest income / interest rate spread		$ 14,564	3.17%		$ 14,771	3.01%
Net interest margin			3.62%			3.57%

In the preceding table, interest income was adjusted to a tax-equivalent basis to recognize the income from the various tax-exempt assets as if the interest was fully taxable. This treatment allows a uniform comparison among the yields on interest-earning assets. The calculations were computed on a fully tax-equivalent basis using the corporate federal tax rate of 34%. Net interest spread represents the difference between the yield on interest-earning assets and the rate on interest-bearing liabilities. Net interest margin represents the ratio of net interest income to total average interest-earning assets.

Provision for loan losses

The provision for loan losses represents the necessary amount to charge against current earnings, the purpose of which is to increase the allowance for loan losses to a level that represents management's best estimate of known and inherent losses in the Company's loan portfolio. Loans and leases determined to be uncollectible are charged-off against the allowance for loan losses. The required amount of the provision for loan losses, based upon the adequate level of the allowance for loan losses, is subject to ongoing analysis of the loan portfolio. The Company's Special Assets Committee meets periodically to review problem loans and leases. The committee is comprised of management, including the senior loan officer, the chief risk officer, loan officers, loan workout officers and collection personnel. The committee reports quarterly to the Credit Administration Committee of the Board of Directors.

Management continuously reviews the risks inherent in the loan and lease portfolio. Specific factors used to evaluate the adequacy of the loan loss provision during the formal process include:

- specific loans that could have loss potential;
- levels of and trends in delinquencies and non-accrual loans;
- levels of and trends in charge-offs and recoveries;
- trends in volume and terms of loans;
- changes in risk selection and underwriting standards;
- changes in lending policies, procedures and practices;
- experience, ability and depth of lending management;
- national and local economic trends and conditions; and
- changes in credit concentrations.

The provision for loan losses was $3,125,000 for the third quarter and $3,850,000 for the nine month period ending September 30, 2009, as compared to $130,000 of requirements for the same 2008 quarter and $255,000 for the same 2008 nine month period. The sizeable provision increase was due to internally classified credit downgrades stemming from a proactive internal review of large commercial credits, sustained weakening economic conditions and declining real estate values. In reviewing the loans for specific performance, delinquency and collateral sufficiency, management concluded that there were several loans in the commercial loan portfolio that lacked, or may in the near-term lack, the ability to pay in accordance with contractual terms. As such, the risk ratings of those loans were downgraded. Approximately 46% of the provision for the current quarter was attributable to the credit downgrades of five loan relationships aggregating $13,125,000 in outstanding loans. These five loan relationships are unrelated to one another and are in diverse industries. The Company has taken measures to aggressively manage these credits including the setting of specific action plans and benchmarks to resolve these downgraded credits as well as the non-performing loans. For a further discussion on non-performing loans, see "Non-performing assets" under the caption "Comparison of financial condition at September 30, 2009 and December 31, 2008", below.

The allowance for loan losses was $6,725,000 at September 30, 2009 compared to $4,206,000 at September 30, 2008. For a further discussion on the allowance for loan losses, see "Allowance for loan losses" under the caption "Comparison of financial condition at September 30, 2009 and December 31, 2008", below.

Other (loss) income

In the third quarter of 2009, the Company recorded a net non-interest loss of $1,293,000 compared to net non-interest income of $844,000 recorded in the third quarter of 2008. The decline in non-interest earnings was from a non-cash OTTI charge of $2,432,000 recorded in the third quarter of 2009 compared to a $403,000 OTTI charge recorded in the third quarter of 2008. The charges are related to credit-related OTTI from the Company's investment in pooled trust preferred securities. See note 3, "Investment securities" for a further discussion on the Company's portfolio of pooled

trust preferred securities. Adding to the decline in non-interest earnings, the Company wrote down, to fair value, the carrying amount of its investment in two foreclosed assets held-for-sale by a total of $78,000. There were no similar write-downs in 2008. The assets represent two commercial real estate properties acquired in foreclosure during 2008. The current year subsequent write-downs were based on sales indications received by the Company that were less than the carrying value of the properties. Fee income from deposits and loans declined from lower service charges on deposit accounts and higher mortgage loan servicing rights amortization. The decline in deposit fees was mostly from lower volume of overdraft charges. Partially offsetting these declines in non-interest earnings was increased gains from mortgage banking services which increased by $75,000 in the quarter-to-quarter comparison.

For the nine months ended September 30, 2009, other income declined $1,927,000, or 57%, compared to the nine months ended September 30, 2008. The decline was from the $2,758,000 OTTI charge from the pooled trust preferred securities portfolio, as explained above, recorded in the first nine months of the current year compared to OTTI charges of $403,000 recorded in the same period of 2008. Service charges from deposit accounts declined $259,000, or 12%, due to lower volumes of overdraft transactions. In the first nine months of 2009, the Company sold $90,045,000 of residential mortgage loans and recognized gains of $958,000, an increase of $742,000, compared to gains of $216,000 recognized during the first nine months of 2008. Included in these sales for the current year were $10,838,000 of loans transferred from the loan and lease portfolio to loans AFS during the first quarter of the current year and simultaneously sold compared to $28,102,000 in the previous year.

Other operating expenses

For the quarter ended September 30, 2009, other (non-interest) expenses increased $437,000, or 9%, compared to the quarter ended September 30, 2008. The other category of non-interest expenses increased by $473,000, or 41%. In the third quarter of 2009, the Company’s FDIC insurance premium was $142,000 greater than the premium incurred in the 2008 quarter. The current quarter includes the recognition of $162,000 in consulting costs for services of the Company’s former chief executive officer. In addition, collection expense increased $159,000 due to more legal and other costs associated with non-accrual, delinquent, repossessions and other problem-loans. The increase in premises and equipment was mostly from added depreciation expense and property insurance for the new West Scranton branch expansion project that opened during the third quarter of 2008 and increased equipment maintenance mostly in information technology. The decrease in advertising expense of $125,000, or 51%, was due to the new branch grand opening celebration in 2008 which did not recur in 2009.

For the nine months ended September 30, 2009, non-interest related expenses increased $1.0 million, or 7%, compared to the nine months ended September 30, 2008. For the first nine months of 2009, the Company’s FDIC insurance premium was $525,000 greater than the premium incurred in the same 2008 period. The increase was caused by higher premiums and a $255,000 special assessment imposed by the FDIC to all member-insured banks on June 30, 2009. The current year includes the recognition of $162,000 in consulting costs for services of the Company’s former chief executive officer. The 2% increase in salary and benefits was due to a full nine months of operations of the Company’s West Scranton branch that was not operational until the third quarter of 2008, a Company’s executive officer was re-employed during the middle of the first quarter of 2008 compared to a full nine-month impact in the current year, increased health care costs, higher commissions earned on production by our asset management staff and partially offset by lower stock-based compensation. The $300,000, or 13%, increase in premises and equipment is from depreciation and other ancillary occupancy expenses for the new West Scranton branch and higher equipment maintenance and depreciation, mostly for information technology. An increase in the level of problem loans and ORE activity, as a result of our continued efforts to resolve non-performing assets, resulted in a $114,000 increase in the costs associated with foreclosure, the operating costs of property ownership as well as an increase in collection expense of $113,000 in the current year nine month period compared to the same period in 2008. The 32% decrease in advertising stems from activity related to opening a new branch in 2008 that did not occur in 2009.

(Credit) provision for income taxes

The pre-tax accounting loss for both the third quarter and year-to-date periods ended September 30, 2009 resulted in a tax benefit compared to a tax provision in 2008.

Comparison of financial condition at
September 30, 2009 and December 31, 2008

Overview

Consolidated assets declined $9,720,000, or 2%, during the nine months ended September 30, 2009. The decline was caused by a $52,891,000, or 59%, reduction in total borrowings, partially offset by a $43,947,000, or 10%, increase in total deposits. The reduction in borrowings was from implementing a de-leveraging strategy during the year that used the proceeds from the sale of residential mortgage loans and deposit growth to reduce overnight borrowings and FHLB advances.

Investment securities

At the time of purchase, management classifies investment securities into one of three categories: trading, AFS or held-to- maturity (HTM). To date, management has not purchased any securities for trading purposes. Most of the securities purchased are classified as AFS even though there is no immediate intent to sell them. The AFS designation affords management the flexibility to sell securities and position the balance sheet in response to capital levels, liquidity needs or changes in market conditions. Securities AFS are carried at fair value in the consolidated balance sheet with an adjustment to shareholders' equity, net of tax, presented under the caption "Accumulated other comprehensive income (loss)." Securities designated as HTM are carried at amortized cost and represent debt securities that the Company has the ability and intent to hold until maturity.

As of September 30, 2009, the carrying value of investment securities totaled $83,142,000, or 15% of total assets, compared to $84,187,000, or 15% of total assets, at December 31, 2008. At September 30, 2009, approximately 12% of the carrying value of the investment portfolio was comprised of mortgage-backed securities that amortize and provide monthly cash flow. Agency, municipal and corporate bonds comprised 42%, 36% and 10%, respectively, of the investment portfolio at September 30, 2009.

During the nine months ended September 30, 2009, total investments decreased $1,045,000. Investment securities are comprised of HTM and AFS securities with carrying values of $740,000 and $82,402,000, respectively. As of September 30, 2009, the AFS debt securities were recorded with a net unrealized loss in the amount of $10,720,000 and equity securities were recorded with an unrealized net gain of $124,000.

A comparison of investment securities at September 30, 2009 and December 31, 2008 is as follows (dollars in thousands):

	September 30, 2009			December 31, 2008		
		Amount	%		Amount	%
U.S. government agencies	$	34,996	42.1	$	43,507	51.6
Mortgage-backed securities		10,097	12.1		12,439	14.8
State & municipal subdivisions		29,764	35.8		17,553	20.9
Pooled trust preferred securities		7,839	9.5		10,260	12.2
Equity securities		446	0.5		428	0.5
Total investments	$	83,142	100.0	$	84,187	100.0

Quarterly, management performs a review of the investment portfolio to determine the cause of declines in the fair value of each security. The Company uses inputs provided by independent third parties to determine the fair value of its investment securities portfolio. Inputs provided by the third party are reviewed and corroborated by management. Evaluations of the causes of the unrealized losses are performed to determine whether impairment is temporary or other-than-temporary. Considerations such as the Company's intent and ability to hold the securities to maturity, recoverability of the invested amounts over the intended holding period, the length of time and the severity in pricing decline below cost, the interest rate environment, receipts of amounts contractually due and whether or not there is an active market for the security, for example, are applied, along with the financial condition of the issuer for management to make a realistic judgment of the probability that the Company will be unable to collect all amounts (principal and interest) due in determining whether a security is other-than-temporarily impaired. If a decline in value is deemed to be other-than-temporary, the amortized cost of the security is reduced by the credit impairment amount and a corresponding charge to earnings is recognized. If at the time of sale, call or maturity the proceeds exceed the security's amortized cost, the impairment charge may be fully or partially recovered.

Uncertainty continues to prevail in the financial markets which have increased the volatility in fair value estimates for the securities in the Company's investment portfolio. Though improved since year-end 2008, the fair values of securities continue to be pressured by this uncertainty. Management believes fair value changes, other than for pooled trust preferred securities, are due mainly to interest rate changes and liquidity problems in the financial markets, not deterioration in the creditworthiness of the issuers.

At September 30, 2009 and December 31, 2008, the securities with the most significant reductions in fair value and associated estimated unrealized losses were in the Company's corporate bond portfolio consisting of pooled trust preferred securities issued by banks, thrifts and insurance companies.

Except for the pooled trust preferred securities, fair values of the other investment securities are determined by prices provided by a third-party vendor, who is a provider of financial market data, analytics and related services to financial institutions. For the pooled trust preferred securities portfolio, management is unable to obtain readily attainable and realistic pricing from market traders due to a lack of active market participants and therefore management has determined that the market for these securities is inactive.

The Company owns 13 tranches of pooled trust preferred securities. The market for these securities at September 30, 2009 is inactive and markets for similar securities were also not active. The inactivity was evidenced first by a

significant widening of the bid-ask spread in the brokered markets in which pooled trust preferred securities trade and then by a significant decrease in the volume of trades relative to historical levels. The new-issue market is also inactive as no new pooled trust preferred securities have been issued since 2007. There are currently very few market participants who are willing and / or able to transact for these securities. Given the conditions in the debt markets today and the absence of observable transactions in the secondary and new issue markets, management determined:

- The few observable transactions and market quotations that were available were not reliable for purposes of determining fair value at September 30, 2009,

- An income valuation approach (present value technique) that maximizes the use of relevant observable inputs and minimizes the use of unobservable inputs will be equally or more representative of fair value than the market approach valuation technique, and

- The pooled trust preferred securities are classified within Level 3 of the fair value hierarchy because significant adjustments are required to determine fair value at the measurement date. The valuations of the Company’s pooled trust preferred securities were prepared by an independent third party. Their approach to determine fair value involved the following:

- o Data about the issue structure as defined in the indenture and the underlying collateral were collected,
- o The credit quality of the collateral is estimated using issuer-specific probability of default values,
- o The default probabilities also considered the potential for 50% correlation among issuers within the same industry (e.g. banks with other banks) and 30% correlation between industries (e.g. banks vs. insurance),
- o The loss given default, or amount of cash lost to the investor when a debt asset defaults, was assumed to be 100% (no recovery) based upon Moody's research. This replicates the historically high default loss levels on trust preferred instruments,
- o The cash flows were forecast for the underlying collateral and applied to each tranche to determine the resulting distribution among the securities. This ascertains which investors are paid and who takes a loss. Thus, these cash flow projections capture the credit risk,
- o The expected cash flows utilize no prepayments and were discounted utilizing three-month LIBOR as the risk-free rate for the base case and then added a 300bp liquidity premium as the discount rate to calculate the present value of the security,
- o The effective discount rates on an overall basis range from 8.90% to 63.52% and are highly dependent upon the credit quality of the collateral, the relative position of the tranche in the capital structure of the security and the prepayment assumptions, and
- o The calculations were modeled in several thousand scenarios using a Monte Carlo engine to establish a distribution of intrinsic values and the average was used for valuation purposes.

Based on the technique described, the Company determined that as of September 30, 2009, the fair values of five pooled trust preferred securities, PreTSLs VII, IX, XV, XVI and XXV had declined $6,794,000, in total below their amortized cost basis and since the present value of the security's expected cash flows were insufficient to recover the entire amortized cost basis, the securities are deemed to have experienced credit related other-than-temporary impairment of $2,758,000 which was charged to current earnings as a component of other income in the consolidated income statement for the nine months ended September 30, 2009. The Company closely monitors the pooled trust preferred securities market and performs collateral sufficiency and cash flow analyses on at least a quarterly basis. Future analyses could yield results that may indicate further impairment has occurred and therefore require additional write-downs and corresponding other-than-temporary charges to current earnings. The OTTI charges recorded during the first nine months of 2008 amounted to $403,000.

At September 30, 2009, the AFS debt securities portfolio was carried with a net unrealized loss of $10,720,000 compared to a net unrealized loss of $13,486,000 at December 31, 2008. Management believes the cause of the unrealized losses is related to changes in interest rates or the limited trading activity due to recent debt market illiquid conditions and is not directly or fully related to credit quality, which is consistent with its past experience. In addition, the Company has no intent to sell the securities and it is more likely than not that the Company will not be required to sell the securities before recovery of its amortized cost basis. As of September 30, 2009, the Company has the ability and intent to hold its investments for a period of time sufficient for the fair value of the securities to recover, which may be at maturity. For a further discussion on the investment securities portfolio, see note 3, "Investment securities" of the notes to the consolidated financial statements in Part I, Item I, herein.

Federal Home Loan Bank Stock

Investment in FHLB stock is required for membership in the organization and is carried at cost since there is no market value available. The amount the Company is required to invest is dependent upon the relative size of outstanding borrowings the Company has with the FHLB. Excess stock is typically repurchased from the Company at par if the borrowings decline to a predetermined level. Throughout most of 2008, the Company earned a return or dividend on the amount invested. In late December 2008, the FHLB announced that it had suspended the payment of dividends and the repurchase of excess capital stock to preserve its capital level. That decision was based on the FHLB's analysis and consideration of certain negative market trends and the impact those trends had on their financial condition. Based on the financial results of the FHLB for the year-ended December 31, 2008 and for the six months ended June 30, 2009, management believes that the suspension of both the dividend payments and excess capital stock repurchase is temporary in nature. Management further believes that the FHLB will continue to be a primary source of wholesale liquidity for both short- and long-term funding and has concluded that its investment in FHLB stock is not other-than-temporarily impaired. The Company will continue to monitor the financial condition of the FHLB quarterly to assess its ability to resume these activities in the future.

Loans available-for-sale (AFS)

Generally, upon origination, certain residential mortgages are classified as AFS. In the event of market rate increases, fixed-rate loans and loans not immediately scheduled to re-price would no longer produce yields consistent with the current market. In a declining interest rate environment, the Company would be exposed to prepayment risk and, as rates decrease, interest income could be negatively affected. Consideration is given to the Company's current liquidity position and projected future liquidity needs. To better manage prepayment and interest rate risk, loans that meet these conditions may be classified as AFS. The carrying value of loans AFS is at the lower of cost or estimated fair value. If the fair values of these loans fall below their original cost, the difference is written down and charged to current earnings. Subsequent appreciation in the portfolio is credited to current earnings but only to the extent of previous write-downs.

Loans AFS at September 30, 2009 amounted to $881,000 with a corresponding fair value of $894,000, compared to $84,000 and $85,000, respectively, at December 31, 2008. During the nine months ended September 30, 2009, residential mortgage loans with principal balances of $90,045,000 were sold into the secondary market with net gains of approximately $958,000 recognized. Included in the sale was $10,838,000 of residential loans transferred from the loan and lease portfolio during the first quarter of 2009.

Loans and leases

The Company originates commercial and industrial (commercial) and commercial real estate (CRE) loans, residential mortgages, consumer, home equity and construction loans. The relative volume of originations is dependent upon customer demand, current interest rates and the perception and duration of future interest levels. As part of the overall strategy to serve the business community in which we operate, the Company is focused on developing and implementing products and services to the small business community. Not only will this serve to provide credit support to our customers and prospects, but it will continue to diversify our loan portfolio, thereby reducing risks associated with the larger million dollar or more credits. The broad spectrum of products provides diversification that helps manage, to an extent, interest rate and credit concentration risk. Credit risk is further managed through underwriting policies and procedures and loan monitoring practices. Interest rate risk is managed using various asset/liability modeling techniques and analyses. The interest rates on most commercial loans are adjustable with reset intervals of five years or less.

The majority of the Company's loan portfolio is collateralized, at least in part, by real estate in Lackawanna and Luzerne Counties of Pennsylvania. Commercial lending activities generally involve a greater degree of credit risk than consumer lending because they typically have larger balances and are more affected by adverse conditions in the economy. Because payments on commercial loans depend upon the successful operation and management of the properties and the businesses which operate from within them, repayment of such loans may be affected by factors outside the borrower's control. Such factors may include adverse conditions in the real estate market, the economy, the industry or changes in government regulations. As such, commercial loans require more ongoing evaluation and monitoring which occurs with the Bank's credit administration and outsourced loan review functions.

The composition of the loan portfolio at September 30, 2009 and December 31, 2008, is summarized as follows (dollars in thousands):

	September 30, 2009		December 31, 2008			
	Amount	%	Amount	%	Variance	%
Real estate:						
Commercial	$ 183,141	42.8	$ 164,772	37.4	$ 18,369	11.1
Residential	71,222	16.7	98,510	22.3	(27,288)	(27.7)

Construction	9,746	2.3	11,427	2.6	(1,681)	(14.7)
Commercial and industrial	79,014	18.4	80,708	18.3	(1,694)	(2.1)
Consumer	84,051	19.7	85,091	19.3	(1,040)	(1.2)
Direct financing leases	385	0.1	444	0.1	(59)	(13.3)
Gross loans	427,559	100.0	440,952	100.0	$ (13,393)	(3.0)
Allowance for loan losses	(6,725)		(4,745)			
Net loans	$ 420,834		$ 436,207			

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Gross loans decreased from $440,952,000, as of December 31, 2008 to $427,559,000 at September 30, 2009. The decline was predominately from the transfer from the loan and lease portfolio, to the AFS portfolio, and simultaneous sale of $10,838,000 of residential mortgage loans during the first quarter of 2009. The balance of the residential real estate mortgage decline is mostly from net pay-downs during the first three quarters of 2009 as borrowers' desire, during this low-rate environment, is to re-finance their existing mortgage and home equity debt into new lower rate mortgage loans. Most of the mortgage loans that were originated in 2009 were sold on a servicing-retained basis. New commercial business and relationship emphasis has resulted in an increase in commercial real estate loans of $18,369,000, or 11%.

Allowance for loan losses

Management continually evaluates the credit quality of the Company's loan portfolio and performs a formal review of the adequacy of the allowance for loan losses (the allowance) on a quarterly basis. The allowance reflects management's best estimate of the amount of credit losses in the loan portfolio. Management's judgment is based on the evaluation of individual loans, past experience, the assessment of current economic conditions and other relevant factors including the amounts and timing of cash flows expected to be received on impaired loans. Those estimates may be susceptible to significant change. The provision for loan losses represents the amount necessary to maintain an appropriate allowance. Loan losses are charged directly against the allowance when loans are deemed to be uncollectible. Recoveries from previously charged-off loans are added to the allowance when received.

Management applies two primary components during the loan review process to determine proper allowance levels. The two components are a specific loan loss allocation for loans that are deemed impaired and a general loan loss allocation for those loans not specifically allocated. The methodology to analyze the adequacy of the allowance for loan losses is as follows:

- identification of specific impaired loans by loan category;
- calculation of specific allowances where required for the impaired loans based on collateral and other objective and quantifiable evidence;
- determination of homogenous pools by loan category and eliminating the impaired loans;
- application of historical loss percentages (five-year average) to pools to determine the allowance allocation; and
- application of qualitative factor adjustment percentages to historical losses for trends or changes in the loan portfolio, and /or current economic conditions.

Allocation of the allowance for different categories of loans is based on the methodology as explained above. A key element of the methodology to determine the allowance is the Company's credit risk evaluation process, which includes credit risk grading of individual commercial loans. Commercial loans are assigned credit risk grades based on the Company's assessment of conditions that affect the borrower's ability to meet its contractual obligations under the loan agreement. That process includes reviewing borrowers' current financial information, historical payment experience, credit documentation, public information and other information specific to each individual borrower. Upon review, the commercial loan credit risk grade is revised or reaffirmed. The credit risk grades may be changed at any time management feels an upgrade or downgrade may be warranted. The credit risk grades for the commercial loan portfolio are taken into account in the reserve methodology and loss factors are applied based upon the credit risk grades. The loss factors applied are based upon the company's historical experience as well as what management believes to be best practices and within common industry standards. Historical experience reveals there is a direct correlation between the credit risk grades and loan charge-offs. The changes in allocations in the commercial loan portfolio from period-to-period are based upon the credit risk grading system and from periodic reviews of the loan and lease portfolios.

Each quarter, management performs an assessment of the allowance and the provision for loan losses. The Company's Special Assets Committee meets quarterly and the applicable lenders discuss each relationship under review and reach a consensus on the appropriate estimated loss amount based ASC 310 "Receivables" as it relates to loans that are identified for evaluation or that are individually considered impaired. The Special Assets Committee's focus is on ensuring the pertinent facts are considered and the specific reserve amounts determined in accordance with the guidance are reasonable. The assessment process includes the review of all loans on a non-accruing basis as well as a review of certain loans to which the lenders or the Special Assets Committee have assigned a criticized or classified risk rating.

Total charge-offs net of recoveries for the nine months ending September 30, 2009, were $1,870,000, compared to $874,000 in the first nine months of 2008. The higher level of charge-offs recorded in the year primarily resulted from a personal, as well as business bankruptcy filing by one customer and the write-down of a separate impaired loan to current fair value. Commercial real estate loan net charge-offs of $841,000 were recorded during the nine months ending September 30, 2009 versus $539,000 at September 30, 2008. Commercial and industrial loan net charge-offs were $730,000 for the nine months ending September 30, 2009 compared to net charge-offs of $49,000 in the same period of 2008. Residential real estate loan net charge-offs totaled $9,000 for the nine months ending September 30, 2009 compared to $32,000 in the like period of 2008. Consumer loan net charge-offs of $289,000 were recorded during the nine months ending September 30, 2009 versus $255,000 at September 30, 2008. For a discussion on the provision for loan losses, see the "Provision for loan losses," located in the results of operations section of management's discussion and analysis contained herein.

The allowance for loan losses was $6,725,000 at September 30, 2009, an increase of $1,980,000 from December 31, 2008. The increase in the allowance was primarily driven by a migration of commercial loan risk ratings from pass to classified status.

Management believes that the current balance in the allowance for loan losses of $6,725,000 is sufficient to withstand the identified potential credit quality issues that may arise and others unidentified but inherent to the portfolio as of this time. Potential problem loans are those where there is known information that leads management to believe repayment of principal and/or interest is in jeopardy and the loans are currently neither on non-accrual status or past due 90 days or more. Given continuing pressure on property values and the generally uncertain economic backdrop, there could be additional instances which become identified in future periods that may require additional charge-offs and/or increases to the allowance. The ratio of allowance for loan losses to total loans was 1.57% at September 30, 2009 compared to 0.98% at September 30, 2008.

The following tables set forth the activity in the allowance for loan losses and certain key ratios for the period indicated:

	As of and for the nine months ended September 30, 2009	As of and for the twelve months ended December 31, 2008	As of and for the nine months ended September 30, 2008
Balance at beginning of period	$ 4,745,234	$ 4,824,401	$ 4,824,401
Provision charged to operations	3,850,000	940,000	255,000
Charge-offs:			
Real estate:			
Commercial	843,526	565,193	556,789
Residential	9,158	44,800	31,870
Commercial and industrial	746,093	168,021	109,799
Consumer	299,041	350,856	283,783
Total	1,897,818	1,128,870	982,241
Recoveries:			
Real estate:			
Commercial	2,075	18,020	18,020
Residential	-	97	80
Commercial and industrial	16,018	61,233	61,233
Consumer	9,348	30,353	29,073
Total	27,441	109,703	108,406
Net charge-offs	1,870,377	1,019,167	873,835
Balance at end of period	$ 6,724,857	$ 4,745,234	$ 4,205,566
Total loans, end of period	$ 428,439,731	$ 441,036,694	$ 431,293,559

	As of and for the nine months ended September 30, 2009		As of and for the twelve months ended December 31, 2008		As of and for the nine months ended September 30, 2008	
Net charge-offs to:						
Loans, end of period	0.44%		0.23%		0.20%	
Allowance for loan losses	27.81%		21.48%		20.78%	
Provision for loan losses	0.49	x	1.08	x	3.43	x
Allowance for loan losses to:						
Total loans	1.57%		1.08%		0.98%	
Non-accrual loans	0.85	x	1.36	x	1.35	x
Non-performing loans	0.76	x	1.16	x	1.13	x
Net charge-offs	3.60	x	4.66	x	4.81	x
Loans 30-89 days past due and still accruing	$ 3,077,722		$ 1,858,481		$ 1,251,282	
Loans 90 days past due and accruing	$ 1,002,720		$ 604,140		$ 581,824	
Non-accrual loans	$ 7,900,547		$ 3,493,169		$ 3,125,997	
Allowance for loan losses to loans 90 days or more past due and accruing	6.71	x	7.85	x	7.23	x

Non-performing assets

The Company defines non-performing assets as accruing loans past due 90 days or more, non-accrual loans, restructured loans, other real estate owned (ORE) and repossessed assets. As of September 30, 2009, non-performing assets represented 1.81% of total assets compared to 0.90% at September 30, 2008. The increase was driven by the higher level of non-performing loans at September 30, 2009.

In the review of loans for both delinquency and collateral sufficiency, management concluded that there were a number of loans that lacked the ability to repay in accordance with contractual terms. The decision to place loans or leases on a non-accrual status is made on an individual basis after considering factors pertaining to each specific loan. The commercial loans are placed on non-accrual status when management has determined that payment of all contractual principal and interest is in doubt or the loan is past due 90 days or more as to principal and interest, unless well-secured and in the process of collection. Consumer loans secured by real estate are placed on non-accrual status at 120 days past due as to principal and interest, and, unsecured consumer loans are charged-off when the loan is 90 days or more past due as to principal and interest. Uncollected interest income accrued on all non-accrual loans is reversed and charged to interest income.

The majority of the non-performing assets for the period are attributed to non-accruing commercial business loans, non-accruing real estate loans and ORE. Most of the loans are collateralized, thereby mitigating the Company's potential for loss. At September 30, 2009 non-performing loans were $8,903,000 compared to $4,097,000 at December 31, 2008. The increase was primarily driven by one commercial loan relationship of approximately $3 million and two jumbo residential real estate mortgages aggregating about $1.2 million which defaulted in their loan payments and were moved to non-performing status. Action plans for the resolution of each of the Company's non-performing loans have been developed and are periodically updated as needed. There were no restructured loans or repossessed assets at September 30, 2009 or at December 31, 2008. ORE at September 30, 2009 was $1,364,000 and consisted of five properties. At September 30, 2009, the non-accrual loans aggregated $7,901,000 as compared to $3,493,000 at December 31, 2008. Additions to the non-accrual component of the non-performing assets totaling

$7,515,000 were made during the first nine months of the year. These were partially offset by reductions or payoffs of $916,000, charge-offs of $1,646,000, $469,000 of transfers to ORE and $77,000 of loans that returned to performing status. Loans past due 90 days or more and accruing were $1,003,000 at September 30, 2009 and $604,000, at December 31, 2008. The rise is mainly attributed to one commercial loan on which payment was expected by September 30th; however, it was not received until after quarter-end. Non-performing loans to net loans were 2.11% at September 30, 2009, and 0.94% at December 31, 2008. The percentage of non-performing assets to total assets was 1.81% at September 30, 2009, an increase from 0.96% at December 31, 2008, primarily driven by the aforementioned increase in the non-accrual loans component.

The 30-89 day past due loans at September 30, 2009 were $3,077,000 and $1,858,000 at December 31, 2008. The rise in these past due loans was driven by increased commercial and mortgage loan delinquencies as current economic conditions take their toll on borrowers. Approximately, $500,000 of these past due loans were paid to current status shortly after the quarter-end.

The following table sets forth non-performing assets data as of the period indicated:

	September 30, 2009	December 31, 2008	September 30, 2008
Loans past due 90 days or more and accruing	$ 1,002,720	$ 604,140	$ 581,824
Non-accrual loans	7,900,547	3,493,169	3,125,997
Total non-performing loans	8,903,267	4,097,309	3,707,821
Other real estate owned	1,364,397	1,450,507	1,428,507
Total non-performing assets	$ 10,267,664	$ 5,547,816	$ 5,136,328
Net loans including AFS	$ 421,714,874	$ 436,291,460	$ 427,087,993
Total assets	$ 565,999,434	$ 575,718,997	$ 569,543,412
Non-accrual loans to net loans	1.87%	0.80%	0.73%
Non-performing assets to net loans, foreclosed real estate and repossessed assets	2.43%	1.27%	1.20%
Non-performing assets to total assets	1.81%	0.96%	0.90%
Non-performing loans to net loans	2.11%	0.94%	0.87%

The composition of non-performing loans as of September 30, 2009 is as follows (dollars in thousands):

	Gross loan balances	Past due 90 days or more and still accruing	Non-accrual loans	Total non-performing loans	% of gross loans
Real estate:					
Commercial	$ 183,141	$ 905	$ 3,399	$ 4,304	2.35%
Residential	71,222	38	3,306	3,344	4.70%
Construction	9,746	-	-	-	-
Commercial and industrial	79,014	-	840	840	1.06%
Consumer	84,051	60	355	415	0.49%
Direct financing leases	385	-	-	-	-
Total	$ 427,559	$ 1,003	$ 7,900	$ 8,903	2.08%

Foreclosed assets held-for-sale

Foreclosed assets held-for-sale, consisting of ORE, was $1,364,000 at September 30, 2009 comprised of five properties. One property has been sold, a second has a signed sales agreement for its sale and the remainder are listed for sale with realtors.

Other assets

The increase in other assets of $1,338,000, or 15%, from December 31, 2008 to September 30, 2009 was caused mostly from a net increase in the Company’s deferred tax asset related to further declines in the market value of the investment portfolio and an increase in mortgage servicing rights of $462,000 due to high volume of mortgage real estate sales that the Company normally sells into the secondary market on a servicing-retained basis. Contributing to the net increase was $212,000 of prepaid expense replenishments.

Deposits

The Bank is a community-based commercial financial institution, member FDIC, which offers a variety of deposit accounts with varying ranges of interest rates and terms. Deposit products include savings accounts, interest-bearing checking (NOW), money market, non-interest-bearing checking (DDAs) and certificates of deposit accounts. Certificates of deposit accounts, or CDs, are deposits with stated maturities ranging from seven days to ten years. The flow of deposits is significantly influenced by general economic conditions, changes in prevailing interest rates, pricing and competition. Most of the Company's deposits are obtained from the communities surrounding its 11 branch offices and are insured by the FDIC up to the full extent permitted by law. The Bank attempts to attract and retain deposit customers via sales and marketing efforts, new products, quality service, competitive rates and maintaining long-standing customer relationships. To determine deposit product interest rates, the Company considers local competition, market yields and the rates charged for alternative sources of funding such as borrowings. Though we continue to experience intense competition for deposits, our rate-setting strategy includes consideration of liquidity needs, balance sheet structure, cost effective strategies that are mindful of the current interest rate environment and customer needs.

Compared to December 31, 2008 total deposits grew $43,947,000, or 10%, during the nine month period ended September 30, 2009. The growth in total deposits was due to increases in DDAs, savings, NOW and money market accounts of $2,547,000, or 4%, $34,636,000, or 84%, $16,963,000, or 34%, and $9,648,000, or 10%, respectively, partially offset by lower CD balances. The opening of the West Scranton branch during the third quarter of 2008 and bank-wide money market and savings promotions that the Company attempts to tailor to individual customers' needs contributed to growth in deposits during the nine months of 2009. On July 20, 2009, the Company closed its Wyoming Avenue, Scranton branch which then consolidated with the Financial Center branch located on North Washington Avenue, Scranton. The consolidation did not have a material effect on the Company's deposits.

The following table represents the components of deposits as of the date indicated:

	September 30, 2009		December 31, 2008	
	Amount	%	Amount	%
Money market	$ 106,385,512	22.3	$ 96,738,006	22.3
NOW	67,086,761	14.1	50,123,744	11.6
Savings and club	75,962,710	15.9	41,326,616	9.5
Certificates of deposit	147,144,939	30.8	173,680,915	40.1
CDARS	6,688,581	1.4	-	-
Total interest-bearing	403,268,503	84.5	361,869,281	83.5
Non-interest-bearing	73,990,068	15.5	71,442,651	16.5
Total deposits	$ 477,258,571	100.0	$ 433,311,932	100.0

Certificates of deposit of $100,000 or more aggregated $56,863,000 and $74,250,000 at September 30, 2009 and December 31, 2008, respectively. Certificates of deposit of $250,000 or more aggregated $21,441,000 and $35,108,000 at September 30, 2009 and December 31, 2008.

During the first quarter of 2009, the Company began to use the Certificate of Deposit Account Registry Service (CDARS) in order to obtain FDIC insurance protection for customers who have large deposits that at times exceed the FDIC maximum amount of $250,000. In the CDARS program, deposits are sold at varying terms and interest rates, are originated in our own market place and are placed with other financial institutions that are members in the CDARS network. By placing these deposits in other participating institutions, the deposits of our customers are fully insured by the FDIC. In return for deposits we place with network institutions, we can receive from network institutions deposits that are approximately equal in amount of what was placed for our customers. Deposits we receive, or reciprocal deposits, from other institutions are considered brokered deposits. As of September 30, 2009, CDARS represented $6,689,000, or 1%, of total deposits.

Including CDARS, approximately 25% of total CDs are scheduled to mature in 2009. Renewing CDs may re-price to market rates depending on the direction of interest rate movements, the shape of the yield curve, competition, the rate profile of the maturing accounts and depositor preference for alternative products. To help reduce the financial impact of the unpredictable and highly volatile interest rate environment, management will deploy prudent strategies that will diversify the deposit mix across the entire spectrum of products offered. Although we continue to experience intense competition for deposits, we have not adjusted rates above market levels as we consider cost effective strategies, liquidity as well as relationship retention and development when setting interest rates on deposit accounts.

Borrowings

Borrowings are used as a complement to deposit generation as an alternative funding source whereby the Bank will borrow under customer repurchase agreements in the local market, advances from the Federal Home Loan Bank of Pittsburgh (FHLB) and other correspondent banks for asset growth and liquidity needs. Repurchase agreements are

non-insured interest-bearing liabilities that have a perfected security interest in qualified investment securities of the Bank. The FDIC Depositor Protection Act of 2009 requires banks to provide a perfected security interest to the purchasers of uninsured repurchase agreements. Holders of existing contracts that did not conform to the amended requirements were considered unsecured creditors of the Company. In effect, the Company had to enter into new agreements with all repurchase agreement participants. At September 30, 2009, $3.0 million of the reported $5.2 million in repurchase agreements were held by participants who had not renegotiated their contracts. The situation is expected to be resolved during the fourth quarter. The repurchase agreements are offered through a sweep product. A sweep account is designed to ensure that, on a daily basis, an attached DDA is adequately funded and excess DDA funds are transferred, or swept, into an overnight interest-bearing repurchase agreement account. The balance in customer repurchase agreement accounts can fluctuate daily because the daily sweep product is dependent on the level of available funds in depositor accounts. In addition, short-term borrowings may include overnight balances which the Bank may require to fund daily liquidity needs. Overnight balances and repurchase agreements are components of short-term borrowings and FHLB advances are components of long-term debt on the consolidated balance sheets.

The following table represents the components of borrowings as of September 30, 2009 and December 31, 2008 (dollars in thousands):

	September 30, 2009		December 31, 2008	
	Amount	%	Amount	%
Overnight borrowings	$ -	-	$ 25,668	28.5
Repurchase agreements	5,176	13.9	11,412	12.6
Demand note, U.S. Treasury	62	0.2	1,050	1.2
FHLB advances	32,000	85.9	52,000	57.7
Total borrowings	$ 37,238	100.0	$ 90,130	100.0

Borrowings have decreased $52,892,000, or 59%, during the nine months ended September 30, 2009. Overnight borrowings and FHLB advances have declined as a result of the Company's balance sheet de-leveraging and deposit growth. The reduction in repurchase agreements was caused by a combination of pricing, movement of customers to insured products and the volatile nature of the sweep product.

Item 3. Quantitative and Qualitative Disclosure About Market Risk

Management of interest rate risk and market risk analysis

The Company is subject to the interest rate risks inherent in its lending, investing and financing activities. Fluctuations of interest rates will impact interest income and interest expense along with affecting market values of all interest-earning assets and interest-bearing liabilities, except for those assets or liabilities with a short term remaining to maturity. Interest rate risk management is an integral part of the asset/liability management process. The Company has instituted certain procedures and policy guidelines to manage the interest rate risk position. Those internal policies enable the Company to react to changes in market rates to protect net interest income from significant fluctuations. The primary objective in managing interest rate risk is to minimize the adverse impact of changes in interest rates on net interest income along with creating an asset/liability structure that maximizes earnings.

Asset/Liability Management. One major objective of the Company when managing the rate sensitivity of its assets and liabilities is to stabilize net interest income. The management of and authority to assume interest rate risk is the responsibility of the Company's Asset/Liability Committee (ALCO), which is comprised of senior management and members of the board of directors. ALCO meets quarterly to monitor the relationship of interest sensitive assets to interest sensitive liabilities. The process to review interest rate risk is a regular part of managing the Company. Consistent policies and practices of measuring and reporting interest rate risk exposure, particularly regarding the treatment of non-contractual assets and liabilities, are in effect. In addition, there is an annual process to review the interest rate risk policy with the board of directors which includes limits on the impact to earnings from shifts in interest rates.

Interest Rate Risk Measurement. Interest rate risk is monitored through the use of three complementary measures: static gap analysis, earnings at risk simulation and economic value at risk simulation. While each of the interest rate risk measurements has limitations, taken together they represent a reasonably comprehensive view of the magnitude of interest rate risk in the Company and the distribution of risk along the yield curve, the level of risk through time and the amount of exposure to changes in certain interest rate relationships.

Static Gap. The ratio between assets and liabilities re-pricing in specific time intervals is referred to as an interest rate sensitivity gap. Interest rate sensitivity gaps can be managed to take advantage of the slope of the yield curve as well as forecasted changes in the level of interest rate changes.

To manage this interest rate sensitivity gap position, an asset/liability model commonly known as cumulative gap analysis is used to monitor the difference in the volume of the Company's interest-sensitive assets and liabilities that mature or re-price within given time intervals. A positive gap (asset sensitive) indicates that more assets will mature or re-price during a given period compared to liabilities, while a negative gap (liability sensitive) has the opposite effect. The Company employs computerized net interest income simulation modeling to assist in quantifying interest rate risk exposure. This process measures and quantifies the impact on net interest income through varying interest rate changes and balance sheet compositions. The use of this model assists the ALCO to gauge the effects of the interest rate changes on interest-sensitive assets and liabilities in order to determine what impact these rate changes will have upon the net interest spread. At September 30, 2009 the Bank maintained a one-year cumulative gap of positive $37.4 million, or 6.60%, of total assets. The effect of this positive gap position provided a mismatch of assets and liabilities which may expose the Bank to interest rate risk during periods of falling interest rates. Conversely, in an increasing interest rate environment, net interest income could be positively impacted because more assets than liabilities would re-price upward during the one-year period.

Certain shortcomings are inherent in the method of analysis discussed above and presented in the next table. Although certain assets and liabilities may have similar maturities or periods of re-pricing, they may react in different degrees to changes in market interest rates. The interest rates on certain types of assets and liabilities may fluctuate in advance of changes in market interest rates, while interest rates on other types of assets and liabilities may lag behind changes in market interest rates. Certain assets, such as adjustable-rate mortgages, have features which restrict changes in interest rates on a short-term basis and over the life of the asset. In the event of a change in interest rates, prepayment and early withdrawal levels may deviate significantly from those assumed in calculating the table. The ability of many borrowers to service their adjustable-rate debt may decrease in the event of an interest rate increase.

The following table illustrates the Company's interest sensitivity gap position at September 30, 2009 (dollars in thousands):

	Interest sensitivity gap at September 30, 2009				
	Three months or less	Three to twelve months	One to three years	Over three years	Total
Cash and cash equivalents	$ 5,921	$ -	$ -	$ 11,711	$ 17,632
Investment securities (1)(2)	33,936	5,943	15,704	32,340	87,923
Loans (2)	126,192	64,028	104,960	126,535	421,715
Fixed and other assets	-	9,039	-	29,690	38,729
Total assets	$ 166,049	$ 79,010	$ 120,664	$ 200,276	$ 565,999
Total cumulative assets	$ 166,049	$ 245,059	$ 365,723	$ 565,999	
Non-interest bearing transaction deposits (3)	$ -	$ 7,400	$ 20,348	$ 46,242	$ 73,990
Interest-bearing transaction deposits (3)	62,385	30,909	56,086	100,055	249,435
Time deposits	38,297	63,462	41,436	10,639	153,834
Repurchase agreements	5,176	-	-	-	5,176
Short-term borrowings	62	-	-	-	62
Long-term debt	-	-	11,000	21,000	32,000
Other liabilities	-	-	-	3,338	3,338
Total liabilities	$ 105,920	$ 101,771	$ 128,870	$ 181,274	$ 517,835
Total cumulative liabilities	$ 105,920	$ 207,691	$ 336,561	$ 517,835	
Interest sensitivity gap	$ 60,129	$ (22,761)	$ (8,206)	$ 19,002	
Cumulative gap	$ 60,129	$ 37,368	$ 29,162	$ 48,164	
Cumulative gap to total assets	10.62%	6.60%	5.15%	8.51%	

(1) Includes FHLB stock and the net unrealized gains/losses on securities AFS.

(2) Investments and loans are included in the earlier of the period in which interest rates were next scheduled to adjust or the period in which they are due. In addition, loans are included in the periods in which they are scheduled to be repaid based on scheduled amortization. For amortizing loans and mortgage-backed securities, annual prepayment rates are assumed reflecting historical experience as well as management's knowledge and

experience of its loan products.

(3) The Bank's demand and savings accounts are generally subject to immediate withdrawal. However, management considers a certain amount of such accounts to be core accounts having significantly longer effective maturities based on the retention experiences of such deposits in changing interest rate environments. The effective maturities presented are the recommended maturity distribution limits for non-maturing deposits based on historical deposit studies.

Earnings at Risk and Economic Value at Risk Simulations. The Company recognizes that more sophisticated tools exist for measuring the interest rate risk in the balance sheet that extend beyond static re-pricing gap analysis. Although it will continue to measure its re-pricing gap position, the Company utilizes additional modeling for identifying and measuring the interest rate risk in the overall balance sheet. The ALCO is responsible for focusing on "earnings at risk" and "economic value at risk", and how both relate to the risk-based capital position when analyzing the interest rate risk.

Earnings at Risk. Earnings at risk simulation measures the change in net interest income and net income should interest rates rise and fall. The simulation recognizes that not all assets and liabilities re-price one-for-one with market rates (e.g., savings rate). The ALCO looks at "earnings at risk" to determine income changes from a base case scenario under an increase and decrease of 200 basis points in interest rate simulation models.

Economic Value at Risk. Earnings at risk simulation measures the short-term risk in the balance sheet. Economic value (or portfolio equity) at risk measures the long-term risk by finding the net present value of the future cash flows from the Company's existing assets and liabilities. The ALCO examines this ratio quarterly utilizing an increase and decrease of 200 basis points in interest rate simulation models. The ALCO recognizes that, in some instances, this ratio may contradict the "earnings at risk" ratio.

The following table illustrates the simulated impact of 200 basis points upward or downward movement in interest rates on net interest income, net income and the change in the economic value (portfolio equity). This analysis assumes that interest-earning asset and interest-bearing liability levels at September 30, 2009 remain constant. The impact of the rate movements was developed by simulating the effect of rates changing over a twelve-month period from the September 30, 2009 levels:

Earnings at risk:	Rates +200	Rates -200
Percent change in:		
Net interest income	3.4%	0.5%
Net income	11.0	0.9
Economic value at risk:		
Percent change in:		
Economic value of equity	(43.1)	(1.5)
Economic value of equity as a percent of book assets	(3.6)	(0.1)

Economic value has the most meaning when viewed within the context of risk-based capital. Therefore, the economic value may normally change beyond the Company's policy guideline for a short period of time as long as the risk-based capital ratio (after adjusting for the excess equity exposure) is greater than 10%. At September 30, 2009, the Company's risk-based capital ratio was 11.3%.

The table below summarizes estimated changes in net interest income over a twelve-month period beginning October 1, 2009 under alternate interest rate scenarios using the income simulation model described above (dollars in thousands):

Change in interest rates	Net interest income	$ variance	% variance
+200 basis points	$ 21,323	$ 700	3.4%
+100 basis points	20,813	190	0.9
Flat rate	20,623	-	-
-100 basis points	20,777	154	0.7
-200 basis points	20,722	99	0.5

Simulation models require assumptions about certain categories of assets and liabilities. The models schedule existing assets and liabilities by their contractual maturity, estimated likely call date or earliest re-pricing opportunity. Mortgage-backed securities and amortizing loans are scheduled based on their anticipated cash flow including estimated prepayments. For investment securities, the Bank uses a third-party service to provide cash flow estimates in the various rate environments. Savings, money market and NOW accounts do not have a stated maturity or re-pricing term and can be withdrawn or re-priced at any time. This may impact the margin if more expensive alternative sources of deposits are required to fund loans or deposit runoff. Management projects the re-pricing characteristics of these accounts based on historical performance and assumptions that it believes reflect their rate sensitivity. The model reinvests all maturities, repayments and prepayments for each type of asset or liability into the

same product for a new like term at current product interest rates provided by management. As a result, the mix of interest-earning assets and interest bearing-liabilities is held constant.

Derivative Financial Instruments. As part of the Bank's overall interest rate risk strategy, the Company has adopted a policy whereby the Company may periodically use derivative instruments to minimize significant fluctuations in earnings caused by interest rate volatility. This interest rate risk management strategy entails the use of interest rate floors, caps and swaps. In October 2006, the Bank entered into an interest rate floor derivative agreement on $20,000,000 notional value of its prime-based loan portfolio. The purpose of the hedge is to help protect the Bank's interest income in the event interest rates decline below a pre-determined contractual interest rate. The strategy is reflected in the scenarios for earnings and economic value at risk and the net interest income in the two immediately preceding tables. For a further discussion on the Bank's derivative contract, see note 4, "Derivative instruments," contained within the notes to consolidated financial statements in Part I, Item 1.

Liquidity

Liquidity management ensures that adequate funds will be available to meet loan and investment commitments, deposit withdrawals and maturities and normal operating requirements of the Bank. Current sources of liquidity are cash and cash equivalents, asset maturities, calls and principal repayments, loans and investments AFS, growth of core deposits, growth of repurchase agreements, increases in other borrowed funds from correspondent banks and issuance of capital stock. Although regularly scheduled investment and loan payments are dependable sources of daily funds, the sales of both loans and investments AFS, deposit activity and investment and loan prepayments are significantly influenced by general economic conditions and the level of interest rates. During declining interest rate environments, prepayments from interest-sensitive assets tend to accelerate and provide significant liquidity which can be used to invest in other interest-earning assets but at lower market rates. Conversely, in a period of rising interest rates, prepayment from interest-sensitive assets tend to decelerate causing cash flow from mortgage loans and mortgage-backed securities portfolio to decrease. Deposit inflow may accelerate and be invested at higher market interest rates. The Company closely monitors activity in the capital markets and takes appropriate action to ensure that the liquidity levels are adequate for funding, investing and operating activities.

For the nine months ended September 30, 2009, the Company generated approximately $4.9 million of cash. During this period, the Company’s operations provided approximately $13.0 million primarily from the sales of mortgages AFS net of originations and the investing activities provided approximately $1.8 million from pay-downs of loans and bonds and from the sale of foreclosed properties held-for-sale, partially offset by the acquisition of premises and equipment. Partially offsetting these cash generators was a use of $9.9 million in financing activities, mostly from the pay-down of total borrowings net of deposit growth and the payment of cash dividends to shareholders. As of September 30, 2009, the Company maintained $17.6 million of cash and cash equivalents, $82.4 million of investments AFS and $0.9 million of loans AFS. In addition, as of September 30, 2009 the Company had approximately $101.3 million available to borrow from the FHLB, $10.0 million available from other correspondent banks, $2.3 million from the Federal Reserve Bank Discount Window and $57.5 million from CDARS. This combined total of $272.0 million represented 48% of total assets at September 30, 2009. The Company is in the process of renewing its relationship with a former correspondent bank, a provider of up to $20.0 million in overnight funds availability, if needed. The renewal should be completed in the fourth quarter. Management believes the level of current and available liquidity to be strong and adequate to support current operations.

In October 2008, the FDIC announced the Temporary Liquidity Guarantee Program (TLGP) to strengthen confidence and encourage liquidity in the banking system. Among other things, this new program provides full deposit insurance coverage for non-interest bearing deposit transaction accounts in FDIC-insured institutions regardless of the dollar amount. To protect its depositors, the Company has participated in the Transaction Account Guarantee (TAG) component of the TLGP. Under the TAG, all depositors who hold funds in non-interest bearing accounts, or interest-bearing accounts with an interest rate of 0.50% or less, including the Lawyers Trust Accounts, will have a temporary unlimited guarantee from the FDIC which was scheduled to expire on December 31, 2009. To assure an orderly phase out of the TAG component of the TLGP, the FDIC has extended the program, on a voluntary basis to June 30, 2010. Participation in the extended program will require the assessment of a higher premium – from 15 to 25 basis points depending on pre-determined risk factors assigned to financial institutions. To protect the deposit base, the Company has opted to extend its participation in the TAG program. Under the program, through June 30, 2010, all noninterest-bearing transaction accounts will continue to be fully guaranteed by the FDIC for the entire account balance. The Company, rated with the lowest tier 1 risk factor, will be assessed 15 basis points and as a result anticipates to incur an estimated $42,000 of additional FDIC premiums to voluntarily participate in the TAG extension program. Coverage under the TAG program is in addition to and separate from coverage available under the FDIC’s general deposit insurance rules, which insures accounts up to $250,000 until the end of 2013, unless extended.

Capital

During the nine months ended September 30, 2009, shareholders' equity declined $796,000, or 2%, due principally from the net loss generated during the nine months ended September 30, 2009, non-credit related OTTI recorded during the third quarter, the declaration of cash dividends and a decline in the intrinsic value of the Company's cash flow hedge. These items were partially offset by a decline in the unrealized losses in the securities AFS portfolio and issuance of common stock via the Company's Employee Stock Purchase and Dividend Reinvestment Plans.

As of September 30, 2009, the Company reported a net unrealized loss of $6,993,000, net of tax, from the securities AFS portfolio including $3,015,000 of non-credit related OTTI recorded in 2009 from the securities AFS portfolio compared to a net unrealized loss of $8,831,000 as of December 31, 2008. While the unrealized loss position has improved, the prolonged economic downturn has created uncertainty and in certain circumstances illiquidity in the financial and capital markets and has had a sizable negative impact on the fair value estimates for securities in banks' investment portfolios. Management believes these changes are due mainly to liquidity problems in the financial markets and to a lesser extent the deterioration in the creditworthiness of the issuers. For a further discussion on the fair value determination of the Company's investment portfolio, see "Investment securities" under the caption "Comparison of financial condition at September 30, 2009 and December 31, 2008" of Part 1, Item 2, "Management's Discussion and Analysis of Financial Condition and Results of Operations;" and notes 3 and 5, "Investment securities" and "Fair value measurement" in the notes to the consolidated financial statements, incorporated by reference in Part I, Item 1.

During the second quarter of 2008, the Company's Board of Directors announced its intent to initiate a capital stock repurchase program covering up to 50,000 shares of its outstanding capital stock. The repurchased shares would become treasury stock and could be available for issuance under the Company's various stock-based compensation, employee stock purchase and dividend reinvestment (DRP) plans and for general corporate purposes. The repurchases may be made from time-to-time in open-market transactions, subject to availability, pursuant to safe harbor rule 10b-18 under the Securities Exchange Act of 1934. Management has suspended repurchase-plan activity as a prudent means, in light of the current economic pressures on banking, to preserve and grow the Company's capital base. Since the program's inception, the Company has reacquired (at $27.83 per share) and reissued (at $21.11 per share) 17,500 shares to participants in the Company's DRP.

The Company (on a consolidated basis) and the Bank are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possible additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company's and the Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and the Bank must meet specific capital guidelines that involve quantitative measures of their assets, liabilities and certain off-balance-sheet items as calculated under regulatory accounting practices. The capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk-weightings and other factors. Prompt corrective action provisions are not applicable to bank holding companies.

Under these guidelines, assets and certain off-balance sheet items are assigned to broad risk categories, each with appropriate weights. The resulting capital ratios represent capital as a percentage of total risk-weighted assets and certain off-balance sheet items. The appropriate risk-weighting, pursuant to regulatory guidelines, required an increase in the risk-weighting of securities that were recently rated below investment grade, thus significantly inflating the total risk-weighted assets. Compared to December 31, 2008, the total capital and Tier I capital ratios were reduced by the increase in risk-weighted assets. The guidelines require all banks and bank holding companies to maintain a minimum ratio of total risk-based capital to total risk-weighted assets (Total Risk Adjusted Capital) of 8%, including Tier I capital to total risk-weighted assets (Tier I Capital) of 4% and Tier I capital to average total assets (Leverage Ratio) of at least 4%. As of September 30, 2009, the Company and the Bank met all capital adequacy requirements to which it was subject.

The Company continues to closely monitor and evaluate alternatives to enhance its capital ratios as the regulatory and economic environments change. The following table depicts the capital amounts and ratios of the Company and the Bank as of September 30, 2009:

	Actual		For capital adequacy purposes		To be well capitalized under prompt corrective action provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
Total capital (to risk-weighted assets)						
Consolidated	$ 61,798,162	11.3%	≥$ 43,786,753	≥ 8.0%	N/A	N/A
Bank	$ 61,395,511	11.2%	≥$ 43,776,532	≥ 8.0%	≥$ 54,720,665	≥ 10.0%
Tier I capital (to risk-weighted assets)						
Consolidated	$ 55,017,563	10.1%	≥$ 21,893,377	≥ 4.0%	N/A	N/A
Bank	$ 54,670,373	10.0%	≥$ 21,888,266	≥ 4.0%	≥$ 32,832,399	≥ 6.0%

Tier I capital										
(to average assets)										
Consolidated	$	55,017,563	9.6%	≥$	23,010,518	≥	4.0%		N/A	N/A
Bank	$	54,670,373	9.5%	≥$	22,996,223	≥	4.0%	≥$	28,745,278	≥ 5.0%

Other matters – FDIC rulemaking

On September 29, 2009, the Board of Directors of the FDIC adopted a notice of proposed rulemaking that would require insured institutions to prepay their estimated quarterly risk-based assessments for the fourth quarter of 2009 and for all of 2010, 2011 and 2012. The FDIC also voted to adopt a uniform three-basis point increase in assessment rates effective on January 1, 2011. Each institution would record the entire amount of its prepaid assessment as a prepaid expense (asset) as of December 31, 2009. As of December 31, 2009, and each quarter thereafter, each institution would record an expense (charge to earnings) for its regular quarterly assessment for the quarter and an offsetting credit to the prepaid assessment until the asset is exhausted. Once the asset is exhausted, the institution would record an accrued expense payable each quarter for the assessment payment, which would be paid in arrears to the FDIC at the end of the following quarter. If the prepaid assessment is not exhausted by December 30, 2014, any remaining amount would be returned to the depository institution.

Item 4T. Controls and Procedures

As of the end of the period covered by this Quarterly Report on Form 10-Q, an evaluation was carried out by the Company's management, with the participation of its Interim President and Chief Executive Officer and Chief Financial Officer, of the effectiveness of the Company's disclosure controls and procedures, as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934. Based on such evaluation, the Interim President and Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are designed to ensure that information required to be disclosed in the reports the Company files or furnishes under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and regulations, and are operating in an effective manner. The Company made no significant changes in its internal controls over financial reporting or in other factors that materially affected, or are reasonably likely to materially affect, these controls during the last fiscal quarter ended September 30, 2009.

PART II - Other Information

Item 1. Legal Proceedings

The nature of the Company's business generates some litigation involving matters arising in the ordinary course of business. However, in the opinion of the Company, after consultation with legal counsel, no legal proceedings are pending, which, if determined adversely to the Company or the Bank, would have a material effect on the Company's undivided profits or financial condition. No legal proceedings are pending other than ordinary routine litigation incidental to the business of the Company and the Bank. In addition, to management's knowledge, no governmental authorities have initiated or contemplated any material legal actions against the Company or the Bank.

Item 1A. Risk Factors

The following are additional risk factors that should be read in conjunctions with Item 1A, "Risk Factors" that were disclosed in the Company's December 31, 2008 Form 10-K filed with the Securities and Exchange Commission on March 12, 2009.

The Company may need or be compelled to raise additional capital in the future, but that capital may not be available when it is needed and on terms favorable to current shareholders.

Federal banking regulators require the Company and Bank to maintain adequate levels of capital to support their operations. These capital levels are determined and dictated by law, regulation and banking regulatory agencies. In addition, capital levels are also determined by the Company's management and board of directors based on capital levels that they believe are necessary to support the Company's business operations. The Company is evaluating its present and future capital requirements and needs, is developing a comprehensive capital plan and is analyzing capital raising alternatives, methods and options. Even if the Company succeeds in meeting the current regulatory capital requirements, the Company may need to raise additional capital in the near future to support possible loan losses during future periods or to meet future regulatory capital requirements.

Further, the Company's regulators may require it to increase its capital levels. If the Company raises capital through the issuance of additional shares of its common stock or other securities, it would likely dilute the ownership interests of current investors and would likely dilute the per-share book value and earnings per share of its common stock. Furthermore, it may have an adverse impact on the Company's stock price. New investors may also have rights, preferences and privileges senior to the Company's current shareholders, which may adversely impact its current shareholders. The Company's ability to raise additional capital will depend on conditions in the capital markets at that time, which are outside its control, and on its financial performance. Accordingly, the Company

cannot assure you of its ability to raise additional capital on terms and time frames acceptable to it or to raise additional capital at all. If the Company cannot raise additional capital in sufficient amounts when needed, its ability to comply with regulatory capital requirements could be materially impaired. Additionally, the inability to raise capital in sufficient amounts may adversely affect the Company's operations, financial condition and results of operations.

If we conclude that the decline in value of any of our investment securities is other than temporary, we will be required to write down the credit-related portion of the impairment of that security through a charge to earnings.

We review our investment securities portfolio at each quarter-end reporting period to determine whether the fair value is below the current carrying value. When the fair value of any of our investment securities has declined below its carrying value, we are required to assess whether the decline is other than temporary. If we conclude that the decline is other than temporary, we will be required to write down the credit-related portion of the impairment of that security through a charge to earnings. As of September 30, 2009, the book value of the Company's pooled trust preferred securities was $19,300,000 with an estimated fair value of $7,839,000. Changes in the expected cash flows of these securities and/or prolonged price declines have resulted and may result in our concluding in future periods that there is additional impairment of these securities that is other than temporary, which would require a charge to earnings for the portion of the impairment that is deemed to be-credit-related. Due to the complexity of the calculations and assumptions used in determining whether an asset, such as pooled trust preferred securities, is impaired, the impairment disclosed may not accurately reflect the actual impairment in the future.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

None

Item 3. Default Upon Senior Securities

None

Item 4. Submission of Matters to a Vote of Security Holders

None

Item 5. Other Information
None

Item 6. Exhibits

The following exhibits are filed herewith or incorporated by reference as a part of this Form 10-Q:

3(i) Amended and Restated Articles of Incorporation of Registrant. Incorporated by reference to Annex B of the Proxy Statement/Prospectus included in Registrant's Amendment 4 to its Registration Statement No. 333-90273 on Form S-4, filed with the SEC on April 6, 2000.

3(ii) Amended and Restated Bylaws of Registrant. Incorporated by reference to Exhibit 3(ii) to Registrant's Form 8-K filed with the SEC on November 21, 2007.

*10.1 1998 Independent Directors Stock Option Plan of The Fidelity Deposit and Discount Bank, as assumed by Registrant. Incorporated by reference to Exhibit 10.1 to Registrant's Registration Statement No. 333-90273 on Form S-4, filed with the SEC on November 3, 1999.

*10.2 1998 Stock Incentive Plan of The Fidelity Deposit and Discount Bank, as assumed by Registrant. Incorporated by reference to Exhibit 10.2 of Registrant's Registration Statement No. 333-90273 on Form S-4, filed with the SEC on November 3, 1999.

*10.3 Registrant's 2000 Dividend Reinvestment Plan. Incorporated by reference to Exhibit 4 to Registrant's Registration Statement No. 333-45668 on Form S-1, filed with the SEC on September 12, 2000 and as amended by Pre-Effective Amendment No. 1 on October 11, 2000, by Post-Effective Amendment No. 1 on May 30, 2001, by Post-Effective Amendment No. 2 on July 7, 2005 and by Registration Statement No. 333-152806 on Form S-3 filed on August 6, 2008.

*10.4 Registrant's 2000 Independent Directors Stock Option Plan. Incorporated by reference to Exhibit 4.3 to Registrant's Registration Statement No. 333-64356 on Form S-8 filed with the SEC on July 2, 2001.

*10.5 Amendment, dated October 2, 2007, to the Registrant's 2000 Independent Directors Stock Option Plan. Incorporated by reference to Exhibit 10.2 to Registrant's Form 8-K filed with the SEC on October 4, 2007.

*10.6 Registrant's 2000 Stock Incentive Plan. Incorporated by reference to Exhibit 4.4 to Registrant's Registration Statement No. 333-64356 on Form S-8 filed with the SEC on July 2, 2001.

*10.7 Amendment, dated October 2, 2007, to the Registrant's 2000 Stock Incentive Plan. Incorporated by reference to Exhibit 10.1 to Registrant's Form 8-K filed with the SEC on October 4, 2007.

*10.8 Registrant's 2002 Employee Stock Purchase Plan. Incorporated by reference to Exhibit 4.4 to Registrant's Registration Statement No. 333-113339 on Form S-8 filed with the SEC on March 5, 2004.

*10.9 Complete Settlement Agreement and General Release between Michael F. Marranca, Registrant and The Fidelity Deposit and Discount Bank, dated July 30, 2004. Incorporated by reference to Exhibit 99.1 to Registrant's Current Report on Form 8-K filed with the SEC on August 10, 2004.

*10.10 Amendment to the Complete Settlement Agreement and General Release between Michael F. Marranca, Registrant and The Fidelity Deposit and Discount Bank, dated November 4, 2005. Incorporated by reference to Exhibit 99.1 to Registrant's Current Report on Form 8-K filed with the SEC on November 9, 2005.

*10.11 Change of Control Agreements with Salvatore R. DeFrancesco, Registrant and The Fidelity Deposit and Discount Bank, dated March 21, 2006. Incorporated by reference to Exhibit 99.2 to Registrant's Current Report on Form 8-K filed with the SEC on March 27, 2006.

*10.12 Amended and Restated Executive Employment Agreement between Fidelity D & D Bancorp, Inc., The Fidelity Deposit and Discount Bank and Steven C. Ackmann, dated July 11, 2007. Incorporated by reference to Exhibit 10.1 to Registrant's Current Report on Form 8-K filed with the SEC on July 13, 2007.

*10.13 Executive Employment Agreement between Fidelity D & D Bancorp, Inc., The Fidelity Deposit and Discount Bank and Timothy P. O'Brien, dated January 3, 2008. Incorporated by reference to Exhibit 10.1 to Registrant's Current Report on Form 8-K filed with the SEC on January 10, 2008.

*10.14 Executive Employment Agreement between Fidelity D & D Bancorp, Inc., The Fidelity Deposit and Discount Bank and Daniel J. Santaniello, dated February 28, 2008. Incorporated by reference to Exhibit 10.1 to Registrant's Current Report on Form 8-K filed with the SEC on March 3, 2008.

*10.15 Release Agreement between Steven C. Ackmann, Registrant and The Fidelity Deposit and Discount Bank, dated August 31, 2009. Incorporated by reference to Exhibit 99.1 to Registrant's Current Report on Form 8-K filed with the SEC on September 8, 2009.

*10.16 Consulting Agreement between Steven C. Ackmann, former President and Chief Executive Officer of the Registrant and The Fidelity Deposit and Discount Bank, and The Fidelity Deposit and Discount Bank, dated September 1, 2009. Incorporated by reference to Exhibit 99.2 to Registrant's Current Report on Form 8-K filed with the SEC on September 8, 2009.

11 Statement regarding computation of earnings per share. Included herein in Note No. 4, "Earnings per share," contained within the Notes to Consolidated Financial Statements, and incorporated herein by reference.

31.1 Rule 13a-14(a) Certification of Principal Executive Officer, filed herewith.

31.2 Rule 13a-14(a) Certification of Principal Financial Officer, filed herewith.

32.1 Certification of Principal Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, filed herewith.

32.2 Certification of Principal Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, filed herewith.

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* Management contract or compensatory plan or arrangement.

FIDELITY D & D BANCORP, INC.

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.

	FIDELITY D & D BANCORP, INC.
Date: November 12, 2009	/s/ Patrick J. Dempsey Patrick J. Dempsey Interim President and Chief Executive Officer
Date: November 12, 2009	/s/ Salvatore R. DeFrancesco, Jr. Salvatore R. DeFrancesco, Jr., Treasurer and Chief Financial Officer

EXHIBIT INDEX

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3(i) Amended and Restated Articles of Incorporation of Registrant. Incorporated by reference to Annex B of the Proxy Statement/Prospectus included in Registrant's Amendment 4 to its Registration Statement No. 333-90273 on Form S-4, filed with the SEC on April 6, 2000.	*
3(ii) Amended and Restated Bylaws of Registrant. Incorporated by reference to Exhibit 3(ii) to Registrant's Form 8-K filed with the SEC on November 21, 2007.	*
10.1 1998 Independent Directors Stock Option Plan of The Fidelity Deposit and Discount Bank, as assumed by Registrant. Incorporated by reference to Exhibit 10.1 to Registrant's Registration Statement No. 333-90273 on Form S-4, filed with the SEC on November 3, 1999.	*
10.2 1998 Stock Incentive Plan of The Fidelity Deposit and Discount Bank, as assumed by Registrant. Incorporated by reference to Exhibit 10.2 of Registrant's Registration Statement No. 333-90273 on Form S-4, filed with the SEC on November 3, 1999.	*
10.3 Registrant's 2000 Dividend Reinvestment Plan. Incorporated by reference to Exhibit 4 to Registrant's Registration Statement No. 333-45668 on Form S-1, filed with the SEC on September 12, 2000 and as amended by Pre-Effective Amendment No. 1 on October 11, 2000, by Post-Effective Amendment No. 1 on May 30, 2001, by Post-Effective Amendment No. 2 on July 7, 2005 and by Registration Statement No. 333-152806 on Form S-3 filed on August 6, 2008.	*
10.4 Registrant's 2000 Independent Directors Stock Option Plan. Incorporated by reference to Exhibit 4.3 to Registrant's Registration Statement No. 333-64356 on Form S-8 filed with the SEC on July 2, 2001.	*
10.5 Amendment, dated October 2, 2007, to the Registrant's 2000 Independent Directors Stock Option Plan. Incorporated by reference to Exhibit 10.2 to Registrant's Form 8-K filed with the SEC on October 4, 2007.	*
10.6 Registrant's 2000 Stock Incentive Plan. Incorporated by reference to Exhibit 4.4 to Registrant's Registration Statement No. 333-64356 on Form S-8 filed with the SEC on July 2, 2001.	*
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* Incorporated by Reference