

FIRST NATIONAL COMMUNITY BANCORP INC
Form 10-Q
November 06, 2015

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2015

OR

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

For the transition period from to

Commission File No. 000-53869

FIRST NATIONAL COMMUNITY BANCORP, INC.

(Exact Name of Registrant as Specified in Its Charter)

Common Stock, \$1.25 par value **16,500,945 shares**
(Title of Class) (Outstanding at November 6, 2015)

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Part I - Financial Information**Item 1 - Financial Statements****FIRST NATIONAL COMMUNITY BANCORP, INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION****(unaudited)**

	September 30, 2015	December 31, 2014
(dollars in thousands, except share data)		
Assets		
Cash and cash equivalents:		
Cash and due from banks	\$20,631	\$22,657
Interest-bearing deposits in other banks	10,383	13,010
Total cash and cash equivalents	31,014	35,667
Securities available for sale, at fair value	249,228	218,989
Stock in Federal Home Loan Bank of Pittsburgh, at cost	4,298	2,803
Loans held for sale	4,634	603
Loans, net of allowance for loan and lease losses of \$9,825 and \$11,520	713,341	658,747
Bank premises and equipment, net	11,258	11,003
Accrued interest receivable	2,618	2,075
Intangible assets	179	302
Bank-owned life insurance	29,232	28,817
Other real estate owned	1,618	2,255
Other assets	7,799	8,768
Total assets	\$1,055,219	\$970,029
Liabilities		
Deposits:		
Demand (non-interest-bearing)	\$152,038	\$124,064
Interest-bearing	700,004	671,272
Total deposits	852,042	795,336
Borrowed funds		
Federal Home Loan Bank of Pittsburgh advances	93,058	61,194
Subordinated debentures	14,000	25,000
Junior subordinated debentures	10,310	10,310
Total borrowed funds	117,368	96,504
Accrued interest payable	11,187	10,262
Other liabilities	14,989	16,529

Total liabilities	995,586	918,631
Shareholders' equity		
Preferred shares (\$1.25 par)		
Authorized: 20,000,000 shares at September 30, 2015 and December 31, 2014		
Issued and outstanding: 0 shares at September 30, 2015 and December 31, 2014	-	-
Common shares (\$1.25 par)		
Authorized: 50,000,000 shares at September 30, 2015 and December 31, 2014		
Issued and outstanding: 16,500,945 shares, September 30, 2015 and 16,484,419 shares, December 31, 2014	20,626	20,605
Additional paid-in capital	61,939	61,781
Accumulated deficit	(25,495)	(32,126)
Accumulated other comprehensive income	2,563	1,138
Total shareholders' equity	59,633	51,398
Total liabilities and shareholders' equity	\$1,055,219	\$970,029

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

FIRST NATIONAL COMMUNITY BANCORP, INC. AND SUBSIDIARIES**CONSOLIDATED STATEMENTS OF INCOME****(unaudited)**

(dollars in thousands, except share data)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
Interest income				
Interest and fees on loans	\$6,693	\$6,852	\$19,640	\$19,958
Interest and dividends on securities:				
U.S. government agencies	1,061	893	3,044	2,496
State and political subdivisions, tax-free	19	409	91	1,679
State and political subdivisions, taxable	324	76	447	271
Other securities	92	74	331	206
Total interest and dividends on securities	1,496	1,452	3,913	4,652
Interest on interest-bearing deposits in other banks	10	8	42	44
Total interest income	8,199	8,312	23,595	24,654
Interest expense				
Interest on deposits	677	751	2,003	2,435
Interest on borrowed funds:				
Interest on Federal Home Loan Bank of Pittsburgh advances	128	125	367	334
Interest on subordinated debentures	162	575	1,290	1,706
Interest on junior subordinated debentures	50	50	150	149
Total interest on borrowed funds	340	750	1,807	2,189
Total interest expense	1,017	1,501	3,810	4,624
Net interest income before credit for loan and lease losses	7,182	6,811	19,785	20,030
Credit for loan and lease losses	(191)	(54)	(340)	(5,629)
Net interest income after credit for loan and lease losses	7,373	6,865	20,125	25,659
Non-interest income				
Deposit service charges	799	781	2,218	2,217
Net gain on the sale of securities	4	2,958	2,302	6,006
Net gain on the sale of mortgage loans held for sale	13	57	69	223
Net loss on the sale of education loans	-	-	-	(13)
Net gain on the sale of other real estate owned	129	35	145	103
Gain on branch divestitures	-	-	-	607
Loan-related fees	94	101	290	292
Income from bank-owned life insurance	145	165	415	496
Legal settlements	-	-	184	2,127
Other	195	345	720	799
Total non-interest income	1,379	4,442	6,343	12,857
Non-interest expense				
Salaries and employee benefits	3,240	3,316	9,582	9,809

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Occupancy expense	500	438	1,665	1,554
Equipment expense	408	355	1,234	1,068
Advertising expense	86	109	335	353
Data processing expense	471	508	1,420	1,556
Regulatory assessments	203	266	711	1,389
Bank shares tax	217	21	652	372
Expense of other real estate owned	91	514	338	2,495
Legal expense	80	268	331	1,428
Professional fees	193	306	780	1,240
Insurance expenses	128	196	528	757
Other operating expenses	798	1,486	2,301	2,718
Total non-interest expense	6,415	7,783	19,877	24,739
Income before income taxes	2,337	3,524	6,591	13,777
Provision (credit) for income taxes	-	166	(40) 326
Net income	\$2,337	\$3,358	\$6,631	\$13,451

Earnings per share

Basic	\$0.14	\$0.20	\$0.40	\$0.82
Diluted	\$0.14	\$0.20	\$0.40	\$0.82

Cash dividends declared per common share

	\$-	\$-	\$-	\$-
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WEIGHTED AVERAGE NUMBER OF SHARES

OUTSTANDING:

Basic	16,500,945	16,471,569	16,497,373	16,471,569
Diluted	16,500,945	16,471,569	16,497,373	16,471,851

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

FIRST NATIONAL COMMUNITY BANCORP, INC. AND SUBSIDIARIES**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME****(unaudited)**

(dollars in thousands)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
Net income	\$2,337	\$3,358	\$6,631	\$13,451
Other comprehensive income (loss):				
Unrealized gains (losses) on securities available for sale	3,465	(482)	4,461	10,528
Taxes	(1,178)	163	(1,516)	(3,580)
Net of tax amount	2,287	(319)	2,945	6,948
Reclassification adjustment for gains included in net income	(4)	(2,958)	(2,302)	(5,638)
Taxes	1	1,006	782	1,917
Net of tax amount	(3)	(1,952)	(1,520)	(3,721)
Total other comprehensive income (loss)	2,284	(2,271)	1,425	3,227
Total comprehensive income	\$4,621	\$1,087	\$8,056	\$16,678

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

FIRST NATIONAL COMMUNITY BANCORP, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

For the Nine Months Ended September 30, 2015 and 2014

(unaudited)

(in thousands, except per share data)	Number of Common Shares	Common Stock	Additional Paid-in Capital	Accumulated Deficit	Accumulated Comprehensive (Loss) Income	Total Shareholders' Equity
Balances, December 31, 2013	16,471,569	\$ 20,589	\$ 61,627	\$ (45,546)	\$ (3,092)	\$ 33,578
Net income for the period	-	-	-	13,451	-	13,451
Restricted stock awards	-	-	65	-	-	65
Other comprehensive income, net of tax of \$1,663	-	-	-	-	3,227	3,227
Balances, September 30, 2014	16,471,569	\$ 20,589	\$ 61,692	\$ (32,095)	\$ 135	\$ 50,321
Balances, December 31, 2014	16,484,419	\$ 20,605	\$ 61,781	\$ (32,126)	\$ 1,138	\$ 51,398
Net income for the period	-	-	-	6,631	-	6,631
Common shares issued under long-term incentive compensation plan	16,526	21	(21)	-	-	-
Restricted stock awards	-	-	179	-	-	179
Other comprehensive income, net of tax of \$734	-	-	-	-	1,425	1,425
Balances, September 30, 2015	16,500,945	\$ 20,626	\$ 61,939	\$ (25,495)	\$ 2,563	\$ 59,633

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

FIRST NATIONAL COMMUNITY BANCORP, INC. AND SUBSIDIARIES**CONSOLIDATED STATEMENTS OF CASH FLOWS****(unaudited)**

(in thousands)	Nine Months Ended September 30,	
	2015	2014
Operating activities:		
Net income	\$6,631	\$13,451
Adjustments to reconcile net income to net cash provided by operating activities:		
Investment securities amortization, net	1,173	953
Equity in trust	(5)	(4)
Depreciation and amortization	1,168	1,068
Stock-based compensation	179	65
Credit for loan and lease losses	(340)	(5,629)
Credit for off-balance sheet commitments	(27)	(201)
Gain on the sale of available-for-sale securities	(2,302)	(5,638)
Gain on the sale of held-to-maturity securities	-	(368)
Gain on the sale of loans held for sale	(69)	(223)
Loss on the sale of education loans	-	13
Gain on branch divestitures	-	(607)
Loss on the disposition of bank premises and equipment and other assets	-	352
Gain on the sale of other real estate owned	(145)	(103)
Valuation adjustment of other real estate owned	208	2,199
Income from bank-owned life insurance	(415)	(496)
Proceeds from the sale of loans held for sale	1,982	6,806
Funds used to originate loans held for sale	(1,352)	(5,934)
(Increase) decrease in accrued interest receivable	(543)	33
Decrease (increase) in other assets	829	(64)
Increase in accrued interest payable	925	1,783
Decrease in other liabilities	(2,221)	(333)
Total adjustments	(955)	(6,328)
Net cash provided by operating activities	5,676	7,123
Cash flows from investing activities:		
Maturities, calls and principal payments of available-for-sale securities	7,326	5,965
Proceeds from the sale of available-for-sale securities	78,765	78,582
Proceeds from the sale of held-to-maturity securities	-	2,686
Purchases of available-for-sale securities	(113,042)	(88,528)
Purchase of Federal Home Loan Bank of Pittsburgh stock	(1,495)	(2,210)
Proceeds from the sale of education loans	-	2,537
Net increase in loans to customers	(58,975)	(33,095)
Proceeds from the sale of other real estate owned	697	1,268
Proceeds from the sale of bank premises and equipment	-	2,504

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Purchases of property and equipment	(1,175)	(982)
Net cash used in investing activities	(87,899)	(31,273)

Cash flows from financing activities:

Net increase (decrease) in deposits	56,706	(81,076)
Net proceeds from Federal Home Loan Bank of Pittsburgh advances - overnight	19,500	-
Proceeds from Federal Home Loan Bank of Pittsburgh advances - term	142,947	194,235
Repayment of Federal Home Loan Bank of Pittsburgh advances - term	(130,583)	(152,572)
Principal reduction on subordinated debentures	(11,000)	-
Net cash provided by (used in) financing activities	77,570	(39,413)
Net decrease in cash and cash equivalents	(4,653)	(63,563)
Cash and cash equivalents at beginning of period	35,667	103,556
Cash and cash equivalents at end of period	\$31,014	\$39,993

Supplemental cash flow information

Cash paid during the period for:

Interest	\$2,885	\$2,841
Income taxes	22	238
Other transactions:		
Principal balance of loans transferred to other real estate owned	149	13
Principal balance of loans transferred to held for sale	4,592	-
Bank premises transferred to other real estate owned	-	1,749
Change in deferred gain on sale of other real estate owned	(26)	27

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

FIRST NATIONAL COMMUNITY BANCORP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

Note 1. Basis of Presentation

The consolidated financial statements are comprised of the accounts of First National Community Bancorp, Inc., and its wholly owned subsidiary, First National Community Bank (the “Bank”), as well as the Bank’s wholly owned subsidiaries (collectively, the “Company”). The accounting and reporting policies of the Company conform to accounting principles generally accepted in the United States of America (“GAAP”) and general practices within the banking industry. In the opinion of management, all adjustments necessary for a fair presentation of the results for the three and nine month periods ended September 30, 2015 have been included in the consolidated financial statements. All intercompany balances and transactions have been eliminated in consolidation. Prior period amounts have been reclassified when necessary to conform to the current period’s presentation. These reclassifications did not have an impact on the operating results or financial position of the Company. The operating results and financial position of the Company for the three and nine months ended September 30, 2015 may not be indicative of its future results of operations and financial position.

The preparation of financial statements in accordance with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ significantly from those estimates. Material estimates that are particularly susceptible to change in the near term are the allowance for loan and lease losses (“ALLL”), investment security valuations, the evaluation of investment securities and other real estate owned (“OREO”) for impairment, and the evaluation of deferred income taxes.

These financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company’s audited financial statements, included in its Annual Report filed on Form 10-K as of and for the year ended December 31, 2014 (the “2014 Form 10-K”) and the Company’s Quarterly Reports filed on Form 10-Q for the periods ended March 31, 2015 and June 30, 2015.

Note 2. New Authoritative Accounting Guidance

Accounting Standards Update (“ASU”) 2014-04, Receivables-Troubled Debt Restructurings by Creditors (Subtopic 310-40): “Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure,” clarifies that an in substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (a) the creditor obtaining legal title to residential real estate property upon completion of a foreclosure or (b) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. Additionally, the amendments require interim and annual disclosure of both the amount of foreclosed residential real estate property held by the creditor and the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure according to local requirements of the applicable jurisdiction. The adoption of this guidance on January 1, 2015 did not have a material effect on the operating results or financial position of the Company.

ASU 2014-08, Presentation of Financial Statements (Topic 205) and Property, Plant and Equipment (Topic 360): “Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity,” changes the criteria for reporting a discontinued operation. Under the new guidance, a disposal of a component of an entity or group of components of an entity is required to be reported in discontinued operations if the disposal represents a strategic shift that has (or will have) a major effect on the entity’s operations and financial results. This new guidance reduces complexity by removing the complex and extensive implementation guidance and illustrations that are necessary to apply the current definition of a discontinued operation. The new guidance also requires expanded disclosures about discontinued operations that will provide users with more information about the assets, liabilities, revenues and expenses of a discontinued operation and will require pre-tax income attributable to a disposal of a significant part of an organization that does not qualify for discontinued operations reporting, which will provide users with information about the ongoing trends in a reporting organization’s results from continuing operations. The adoption of this guidance on January 1, 2015 did not have a material effect on the operating results or financial position of the Company.

ASU 2014-11, Transfers and Servicing (Topic 860): “Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures,” changes the accounting for repurchase-to-maturity transactions and repurchase financing arrangements by aligning the accounting for these transactions with the accounting for other typical repurchase agreements. Going forward, these transactions would all be accounted for as secured borrowings. The new guidance eliminates sale accounting for repurchase-to-maturity transactions and supersedes the guidance under which a transfer of a financial assets and a contemporaneous repurchase financing could be accounted for on a combined basis as a forward arrangement, which has resulted in outcomes referred to as off-balance sheet accounting. ASU 2014-11 also requires a new disclosure for transactions economically similar to repurchase agreements in which the transferor retains substantially all of the exposure to the economic return on the transferred financial assets throughout the term of the transaction, and requires expanded disclosure about the nature of the collateral pledged in repurchase agreements and similar transactions accounted for as secured borrowings. The adoption of this guidance on January 1, 2015 did not have a material effect on the operating results or financial position of the Company.

ASU 2014-14, Receivables – Troubled Debt Restructurings by Creditors (Subtopic 310-40): “Classification of Certain Government-Guaranteed Mortgage Loans Upon Foreclosure,” requires that a mortgage loan be derecognized and that a separate other receivable be recognized upon foreclosure if the following conditions are met: (1) the loan has a government guarantee that is not separable from the loan before foreclosure; (2) at the time of foreclosure, the creditor has the intent to convey the real estate property to the guarantor and make a claim on the guarantee, and the creditor has the ability to recover under that claim; and (3) at the time of foreclosure, any amount of the claim that is determined on the basis of the fair value of the real estate is fixed. Upon foreclosure, the separate other receivable should be measured based on the amount of the loan balance (principal and interest) expected to be recovered from the guarantor. The adoption of this guidance on January 1, 2015 did not have a material effect on the operating results or financial position of the Company.

Accounting Guidance to be Adopted in Future Periods

ASU 2014-09, Revenue from Contracts with Customers (Topic 606): Section A, “Summary and Amendments That Create Revenue from Contracts with Customers (Topic 606) and Other Assets and Deferred Costs-Contract with Customers (Subtopic 340-40);” Section B, “Conforming Amendments to Other Topics and Subtopics in the Codification and Status Tables;” and Section C, “Background Information and Basis for Conclusions,” provides a robust framework for addressing revenue recognition issues, upon its effective date, replaces almost all existing revenue recognition guidance, including industry specific guidance, in current GAAP. The core principle of ASU 2014-09 is for companies to recognize revenue to depict the transfer of goods or services to customers in amounts that reflect the consideration to which the company expects to be entitled in exchange for those goods or services. ASU 2014-09 will also result in enhanced interim and annual disclosures, both qualitative and quantitative, about revenue in order to help financial statement users understand the nature, amount, timing and uncertainty of revenue and related cash flows. ASU 2014-09 is effective in annual reporting periods beginning after December 15, 2016 and the interim periods within that year for public business entities, not-for-profit entities that have issued, or are conduit bond obligors for, securities that are traded, listed or quoted on an exchange or over-the-counter market and employee benefit plans that file or furnish financial statements to the SEC. On August 12, 2015, the FASB issued ASU 2015-14, Revenue from Contracts with Customers (Topic 606): “Deferral of the Effective Date,” which defers the adoption of ASU 2014-09 for one year for all entities. Accordingly, the Company will adopt this guidance on January 1, 2018 in accordance with ASU 2015-14, and is currently evaluating the effect this guidance may have on its operating results or financial position.

ASU 2014-12, Compensation – Stock Compensation (Topic 718): “Accounting for Share-Based Payments When the Terms of an Award Provide that a Performance Target Could be Achieved after the Requisite Service Period,” requires a performance target that affects vesting and that can be achieved after the requisite service period to be treated as a performance condition. To account for such awards, an entity should apply existing guidance as it relates to awards with performance conditions that affect vesting. As such, the performance target should not be reflected in estimating the grant-date fair value of the award. Compensation cost should be recognized in the period in which it becomes probable that the performance target will be achieved and should represent compensation cost attributable to the period(s) for which the requisite service already has been rendered. If the performance target becomes probable of being achieved before the end of the requisite service period, the remaining unrecognized compensation cost should be recognized prospectively over the remaining requisite service periods. The total amount of compensation cost

should reflect the number of awards that are expected to vest and should be adjusted to reflect those awards that ultimately vest. ASU 2014-12 is effective for annual periods and interim periods within those annual periods beginning after December 15, 2015. The adoption of this guidance on January 1, 2016 is not expected to have a material effect on the operating results or financial position of the Company.

ASU 2014-15, Presentation of Financial Statements – Going Concern (Subtopic 205-40): “Disclosure of Uncertainties about an Entity’s Ability to Continue as a Going Concern,” defines management’s responsibility to evaluate whether there is substantial doubt about an entity’s ability to continue as a going concern and provide guidance for related footnote disclosures. ASU 2014-15 requires an entity’s management to assess the entity’s ability to continue as a going concern by incorporating and expanding upon certain principles that are currently in U.S. auditing standards. Specifically ASU 2014-15: (1) provides a definition of the term substantial doubt; (2) requires an evaluation as to whether there are conditions or events, considered in the aggregate, that raise substantial doubt about the entity’s ability to continue as a going concern within one year after the date the financial statements are issued (or within one year after the date that the financial statements are available to be issued when applicable); (3) provides principles for considering the mitigating effect of management’s plans; (4) requires certain disclosures when substantial doubt is alleviated; and (5) require an express statement and other disclosures when substantial doubt is not alleviated. ASU 2014-15 is effective for annual periods ending after December 15, 2016, and for annual periods and interim periods thereafter. Early application is permitted. The adoption of this guidance on December 31, 2016 is not expected to have a material effect on the operating results or financial position of the Company.

ASU 2015-01, Income Statement – Extraordinary and Unusual Items (Subtopic 225-20): “Simplifying Income Statement Presentation by Eliminating the Concept of Extraordinary Items,” will alleviate uncertainty for preparers, auditors and regulators because auditors and regulators will no longer be required to evaluate whether a preparer presented an unusual and/or infrequent item appropriately. Although ASU 2015-01 eliminates the concept of extraordinary items, the presentation and disclosure guidance for items that are unusual in nature or infrequent in occurrence has been retained and has been expanded to include items that are both unusual in nature or infrequent in occurrence. The nature and financial effects of each event or transaction is required to be presented as a separate component of income from continuing operations or, alternatively, in the notes to the financial statements. ASU 2015-01 is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. Early adoption of this guidance is permitted provided that the guidance is applied from the beginning of the fiscal year of adoption. The adoption of this guidance on January 1, 2016 is not expected to have a material effect on the operating results or financial position of the Company.

ASU 2015-02, Consolidation (Topic 810): “Amendments to the Consolidation Analysis,” improves targeted areas of the consolidation guidance and reduces the number of consolidation models. The new consolidation standard changes the way reporting enterprises evaluate whether (a) they should consolidate limited partnerships and similar entities, (b) fees paid to a decision maker or service provider are variable interests in a variable interest entity (“VIE”), and (c) variable interests in a VIE held by related parties of the reporting enterprise require the reporting enterprise to consolidate the VIE. It also eliminates the VIE consolidation model based on majority exposure to variability that applied to certain investment companies and similar entities. ASU 2015-02 is effective for public entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. The adoption of this guidance on January 1, 2016 is not expected to have a material effect on the operating results or financial position of the Company.

ASU 2015-03, Interest – Imputation of Interest (Subtopic 835-30): “Simplifying the Presentation of Debt Issuance Costs,” more closely aligns the presentation of debt issuance costs under U.S. GAAP with the presentation under comparable IFRS standards. Under ASU 2015-03, debt issuance costs related to a recognized debt liability will no longer be recorded as a separate asset, but will be presented on the balance sheet as a direct deduction from the debt liability, similar to the presentation of debt discounts. The costs will continue to be amortized to interest expense using the effective interest method. ASU 2015-03 is effective for public entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015, and requires retrospective application to all prior periods presented in the financial statements. Early adoption of this guidance is permitted. The adoption of this guidance on January 1, 2016 is not expected to have a material effect on the operating results or financial position of the Company.

ASU 2015-05, Intangibles – Goodwill and Other Internal-Use Software (Subtopic 350-40): “Customer’s Accounting for Fees Paid in a Cloud Computing Arrangement,” provides explicit guidance on a customer’s accounting for fees paid in a cloud computing environment. Specifically, the amendments in this ASU provide guidance to customers about whether a cloud computing arrangement includes a software license. If a cloud computing arrangement includes a software license, then the customer should account for the software license element of the arrangement consistent with the acquisition of other software licenses. If a cloud computing arrangement does not include a software license, the customer should account for the arrangement as a service contract. ASU 2015-05 is effective for public entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. Early adoption of this

guidance is permitted. The adoption of this guidance on January 1, 2016 is not expected to have a material effect on the operating results or financial position of the Company.

Note 3. Regulatory Matters

The Bank was under a Consent Order (the "Order") from the Office of the Comptroller of the Currency ("OCC") dated September 1, 2010. On March 25, 2015, after meeting all of the requirements of the Order, the Bank was fully and completely released from the Order. The Company was subject to a Written Agreement (the "Written Agreement") with the Federal Reserve Bank of Philadelphia (the "Reserve Bank") dated November 24, 2010. On September 8, 2015, the Company was notified by the Reserve Bank that effective September 2, 2015 it had been fully and completely released from the Written Agreement.

The Company is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material adverse effect on the Company's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, specific capital guidelines that involve quantitative measures of assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices must be met. Capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

In July 2013, the Federal Reserve, the OCC and the FDIC approved the final Basel III capital framework for U.S. banking organizations (the "Regulatory Capital Rules") implementing regulatory capital reforms and changes required by the Dodd-Frank Act.

The Regulatory Capital Rules are effective on January 1, 2014; however, the mandatory compliance date for the Company and the Bank as “standardized approach” banking organizations began on January 1, 2015 and is subject to transitional provisions extending to January 1, 2019. The Regulatory Capital Rules include new risk-based capital and leverage ratios and refine the definition of what constitutes “capital” for purposes of calculating those ratios. The new minimum capital level requirements applicable to the Company and the Bank under the Regulatory Capital Rules are:

- a total risk-based capital ratio of 8.00% (unchanged from current rules);
- a Tier I risk-based capital ratio of 6.00% (increased from 4.00%);
- a new common equity Tier I risk-based capital ratio of 4.50%; and
- a Tier I capital to average assets (“Tier I leverage ratio”) of 4.00% for all institutions.

The Regulatory Capital Rules also establish a “capital conservation buffer” above the new regulatory minimum capital requirements, which must consist entirely of common equity Tier I capital and result in the following minimum ratios effective January 1, 2019:

- a total risk-based capital ratio of 10.50%.
- a Tier I risk-based capital ratio of 8.50%; and
- a common equity Tier I risk-based capital ratio of 7.00%;

The new capital conservation buffer requirement will be phased in beginning in January 2016 at 0.625% of risk-weighted assets and will increase by that amount each year until fully implemented in January 2019 at 2.50%. An institution will be subject to limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses if its capital level falls below the buffer amount. These limitations will establish a maximum percentage of eligible retained income that could be utilized for such actions.

The Regulatory Capital Rules also implement revisions and clarifications consistent with Basel III regarding the various components of Tier I capital, including common equity, unrealized gains and losses, as well as certain instruments that will no longer qualify as Tier I capital, some of which will be phased out over time.

The Regulatory Capital Rules also revise the prompt corrective action framework, which is designed to place restrictions on insured depository institutions, including the Bank, if their capital levels begin to show signs of weakness. These revisions took effect January 1, 2015. Under the prompt corrective action requirements, which are designed to complement the capital conservation buffer, insured depository institutions are required to meet the following increased capital level requirements in order to qualify as “well capitalized”:

- a total risk-based capital ratio of 10.00% (unchanged from current rules);

a Tier I risk-based capital ratio of 8.00% (increased from 6.00%);
a new common equity Tier I risk-based capital ratio of 6.50%; and
a Tier I leverage ratio of 5.00%.

The Regulatory Capital Rules set forth certain changes for the calculation of risk-weighted assets, which are required to be utilized beginning January 1, 2015. The provisions applicable to banking organizations under the “standardized approach” include changes with respect to risk weights for commercial real estate loans, past due exposures and conversion factors for commitments with an original maturity of one year or less.

Current quantitative measures established by regulation to ensure capital adequacy require the Company to maintain minimum amounts and ratios (set forth in the table below) of total capital, Tier I capital, and Tier I common equity (as defined in the regulations) to risk-weighted assets (as defined), and of Tier I capital (as defined) to average assets (as defined).

The Company's and the Bank's actual capital positions at September 30, 2015 and December 31, 2014 are presented in the following table:

Capital Analysis

(in thousands)	September 30, 2015	December 31, 2014
Company:		
Tier I common equity	\$56,964	N/A
Tier I capital	66,964	\$ 59,930
Tier II capital:		
Subordinated notes	9,800	25,000
Allowable portion of allowance for loan and lease losses	9,650	8,591
Total tier II capital	19,450	33,591
Total risk-based capital	86,414	93,521
Total risk-weighted assets	\$771,395	\$ 683,956
Total average assets (for Tier I leverage ratio)	\$1,019,307	\$ 990,346
Bank:		
Tier I common equity	\$92,821	N/A
Tier I capital	92,821	\$ 96,816
Tier II capital:		
Allowable portion of allowance for loan and lease losses	9,645	8,587
Total tier II capital	9,645	8,587
Total risk-based capital	102,466	105,403
Total risk-weighted assets	\$771,002	\$ 683,576
Total average assets (for Tier I leverage ratio)	\$1,018,916	\$ 990,407

The following tables present summary information regarding the Company's and the Bank's risk-based capital and related ratios at September 30, 2015 and December 31, 2014:

	Company		Bank		Minimum Required For Capital Adequacy Purposes Ratio	To Be Well Capitalized Under Prompt Corrective Action Regulations* Ratio			
	Amount	Ratio	Amount	Ratio					
(dollars in thousands)									
September 30, 2015									
Total capital (to risk-weighted assets)	\$86,414	11.20%	\$102,466	13.29%	8.00	%	10.00	%	
Tier I capital (to risk-weighted assets)	66,964	8.68 %	92,821	12.04%	6.00	%	8.00	%	
Tier I common equity (to risk-weighted assets)	56,964	7.38 %	92,821	12.04%	4.50	%	6.50	%	
Tier I capital (to average assets)	66,964	6.57 %	92,821	9.11 %	4.00	%	5.00	%	

	Company		Bank		Minimum Required For Capital Adequacy Purposes Ratio	To Be Well Capitalized Under Prompt Corrective Action Regulations* Ratio			
	Amount	Ratio	Amount	Ratio					
(dollars in thousands)									
December 31, 2014									
Total capital (to risk-weighted assets)	\$93,521	13.67%	\$105,403	15.42%	8.00	%	10.00	%	
Tier I capital (to risk-weighted assets)	59,930	8.76 %	96,816	14.16%	4.00	%	6.00	%	
Tier I capital (to average assets)	59,930	6.05 %	96,816	9.78 %	4.00	%	5.00	%	

*Applies to the Bank only.

Note 4. Loans

The following table summarizes loans receivable, net, by category at September 30, 2015 and December 31, 2014:

(in thousands)	September 30, 2015	December 31, 2014
Residential real estate	\$ 129,444	\$ 122,832
Commercial real estate	249,526	233,473
Construction, land acquisition and development	25,516	18,835
Commercial and industrial	142,425	132,057
Consumer	132,418	122,092
State and political subdivisions	42,219	40,205
Total loans, gross	721,548	669,494
Unearned income	(104)	(98)
Net deferred loan costs	1,722	871
Allowance for loan and lease losses	(9,825)	(11,520)
Loans, net	\$ 713,341	\$ 658,747

The Company has granted loans, letters of credit and lines of credit to certain executive officers and directors of the Company as well as to certain related parties of executive officers and directors. These loans, letters of credit and lines of credit were made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with unrelated persons and, when made, did not involve more than the normal risk of collectability. See Note 11 to these consolidated financial statements for more information about related party transactions.

The Company originates one- to four-family mortgage loans for sale in the secondary market. During the three and nine month periods ended September 30, 2015, the Company sold \$0.3 million and \$1.9 million, respectively, of one- to four-family mortgages. The Company retains servicing rights on these mortgages. During 2015, as part of its asset/liability management strategy, the Company opted to retain up to \$10.0 million in residential mortgages in the loan portfolio. Based on a change in strategy during the third quarter, the Company elected to transfer \$4.6 million of loans previously retained in the portfolio to held for sale at September 30, 2015 and to sell, on the secondary market, all eligible residential mortgages originated going forward. The Company had \$4.6 million and \$603 thousand in residential mortgage loans held-for-sale at September 30, 2015 and December 31, 2014, respectively.

The Company sold substantially all of its education loans, which are categorized as consumer loans, to a third party during the nine months ended September 30, 2014. The education loans had a recorded investment of \$2.6 million at the time of sale. The Company recognized a loss of \$13 thousand upon the sale of these loans which is included in non-interest income for the nine months ended September 30, 2014.

The Company does not have any lending programs commonly referred to as subprime lending. Subprime lending generally targets borrowers with weakened credit histories typically characterized by payment delinquencies, previous charge-offs, judgments, bankruptcies, or borrowers with questionable repayment capacity as evidenced by low credit scores or high debt-burden ratios.

See Note 2 to the Company's consolidated financial statements included in the 2014 Form 10-K for information about the risk characteristics related to the Company's loan segments.

The Company provides for loan losses based on the consistent application of its documented ALLL methodology. Loan losses are charged to the ALLL and recoveries are credited to it. Additions to the ALLL are provided by charges against income based on various factors which, in management's judgment, deserve current recognition of estimated probable losses. Loan losses are charged-off in the period the loans, or portions thereof, are deemed uncollectible. Generally, the Company will record a loan charge-off (including a partial charge-off) to reduce a loan to the estimated recoverable amount based on its methodology detailed below. The Company regularly reviews the loan portfolio and makes adjustments for loan losses in order to maintain the ALLL in accordance with GAAP. The ALLL consists primarily of the following two components:

Specific allowances are established for impaired loans, which are defined by the Company as all loan relationships with an aggregate outstanding balance greater than \$100 thousand that are rated substandard and on non-accrual status, rated doubtful or loss, and all troubled debt restructured loans (“TDRs”). The amount of impairment provided for as an allowance is represented by the deficiency, if any, between the carrying value of the loan and either (a) (1) the present value of expected future cash flows discounted at the loan’s effective interest rate, (b) the loan’s observable market price, or (c) the fair value of the underlying collateral, less estimated costs to sell, for collateral dependent loans. Impaired loans that have no impairment losses are not considered for general valuation allowances described below. If the Company determines that collection of the impairment amount is remote, the Company will record a charge-off.

General allowances are established for loan losses on a portfolio basis for loans that do not meet the definition of impaired. The Company divides its portfolio into loan segments for loans exhibiting similar characteristics. Loans rated special mention or substandard and accruing, which are embedded in these loan segments, are then separated from these loan segments. These loans are then subject to an analysis placing increased emphasis on the credit risk associated with these specific loans. The Company applies an estimated loss rate to each loan segment. The loss rates applied are based on the Company’s own historical loss experience based on the loss rate for each segment of (2) loans with similar risk characteristics in its portfolio. In addition, management evaluates and applies certain qualitative or environmental factors that are likely to cause estimated credit losses associated with the Company’s existing portfolio to differ from historical experience, which are discussed below. This evaluation is inherently subjective, as it requires material estimates that may be susceptible to significant revisions based upon changes in economic and real estate market conditions. Actual loan losses may be significantly more than the ALLL that is established, which could have a material negative effect on the Company’s operating results or financial condition.

Management makes adjustments for loan losses based on its evaluation of several qualitative and environmental factors, including but not limited to:

- changes in national, local, and business economic conditions and developments, including the condition of various market segments;
- changes in the nature and volume of the Company's loan portfolio;
- changes in the Company's lending policies and procedures, including underwriting standards, collection, charge-off and recovery practices and results;
 - changes in the experience, ability and depth of the Company's lending management and staff;
- changes in the quality of the Company's loan review system and the degree of oversight by the Company's Board of Directors;
- changes in the trend of the volume and severity of past due and classified loans, including trends in the volume of non-accrual loans, troubled debt restructurings and other loan modifications;
- the existence and effect of any concentrations of credit and changes in the level of such concentrations;
- the effect of external factors such as competition and legal and regulatory requirements on the level of estimated credit losses in the Company's current loan portfolio; and
- analysis of customers' credit quality, including knowledge of their operating environment and financial condition.

Each quarter, management evaluates the ALLL and adjusts the ALLL as appropriate through a provision for loan losses. While the Company uses the best information available to make evaluations, future adjustments to the ALLL may be necessary if conditions differ substantially from the information used in making the evaluations. In addition, as an integral part of its examination process, the OCC periodically reviews the Company's ALLL. The OCC may require the Company to adjust the ALLL based on its analysis of information available to it at the time of its examination.

Based on its evaluation of the ALLL, management established an unallocated reserve of \$68 thousand and \$45 thousand at September 30, 2015 and December 31, 2014, respectively. As previously mentioned, as part of its evaluation, management applies loss rates to each loan segment of the loan portfolio for each quarter over the previous three years, which have resulted in overall negative historical loss factors and consequently related negative provisions for the commercial and industrial loan segment at September 30, 2015 and the construction, land acquisition and development loan segment at December 31, 2014. Based on the higher risk characteristics inherent in this segment of the portfolio, management reversed the negative provisions related to the negative historical loss factors and established the unallocated reserves.

The following table summarizes activity in the ALLL, by loan category, for the three and nine months ended September 30, 2015 and 2014:

Real Estate

Construction,

(in thousands)	Residential		Land Acquisition and Development	Commercial		State and Political Subdivisions		Unallocated	Total
	Real Estate	Real Estate		and Industrial	Consumer				
Three months ended									
September 30, 2015:									
Allowance for loan losses:									
Beginning balance, July 1, 2015	\$ 1,484	\$ 4,041	\$ 778	\$ 1,878	\$ 1,643	\$ 504	\$ -	\$ -	\$ 10,328
Charge-offs	(66)	-	(683)	(21)	(198)	-	-	-	(968)
Recoveries	23	278	-	140	215	-	-	-	656
Provisions (credits)	(132)	(84)	874	(738)	(147)	(32)	68	-	(191)
Ending balance, September 30, 2015	\$ 1,309	\$ 4,235	\$ 969	\$ 1,259	\$ 1,513	\$ 472	\$ 68	\$ -	\$ 9,825
Three months ended									
September 30, 2014:									
Allowance for loan losses:									
Beginning balance, July 1, 2014	\$ 2,112	\$ 5,133	\$ 923	\$ 1,758	\$ 1,681	\$ 568	\$ -	\$ -	\$ 12,175
Charge-offs	(67)	-	-	(22)	(270)	-	-	-	(359)
Recoveries	9	-	-	69	58	-	-	-	136
Provisions (credits)	(307)	128	(148)	-	258	15	-	-	(54)
Ending balance, September 30, 2014	\$ 1,747	\$ 5,261	\$ 775	\$ 1,805	\$ 1,727	\$ 583	\$ -	\$ -	\$ 11,898
Nine months ended									
September 30, 2015:									
Allowance for loan losses:									
Beginning balance, January 1, 2015	\$ 1,772	\$ 4,663	\$ 665	\$ 2,104	\$ 1,673	\$ 598	\$ 45	\$ -	\$ 11,520
Charge-offs	(135)	(912)	(689)	(163)	(538)	-	-	-	(2,437)
Recoveries	34	296	-	307	445	-	-	-	1,082
Provisions (credits)	(362)	188	993	(989)	(67)	(126)	23	-	(340)
Ending balance, September 30, 2015	\$ 1,309	\$ 4,235	\$ 969	\$ 1,259	\$ 1,513	\$ 472	\$ 68	\$ -	\$ 9,825
Nine months ended									
September 30, 2014:									
Allowance for loan losses:									
Beginning balance, January 1, 2014	\$ 2,287	\$ 6,017	\$ 924	\$ 2,321	\$ 1,789	\$ 679	\$ -	\$ -	\$ 14,017
Charge-offs	(152)	-	-	(172)	(637)	-	-	-	(961)
Recoveries	79	355	3,539	195	303	-	-	-	4,471
Provisions (credits)	(467)	(1,111)	(3,688)	(539)	272	(96)	-	-	(5,629)
Ending balance, September 30, 2014	\$ 1,747	\$ 5,261	\$ 775	\$ 1,805	\$ 1,727	\$ 583	\$ -	\$ -	\$ 11,898

The following table represents the allocation of the ALLL and the related loan balance, by loan category, disaggregated based on the impairment methodology at September 30, 2015 and December 31, 2014:

(in thousands)	Real Estate		Construction, Commercial		Consumer	State and Political Subdivisions	Unallocated	Total
	Residential Real Estate	Commercial Real Estate	Land Acquisition and Development	Commercial and Industrial				
September 30, 2015								
Allowance for loan losses:								
Individually evaluated for impairment	\$5	\$ 303	\$ -	\$ -	\$2	\$ -	\$ -	\$310
Collectively evaluated for impairment	1,304	3,932	969	1,259	1,511	472	68	9,515
Total	\$1,309	\$4,235	\$ 969	\$1,259	\$1,513	\$ 472	\$ 68	\$9,825
Loans receivable:								
Individually evaluated for impairment	\$2,386	\$7,470	\$ 704	\$ 207	\$353	\$ -	\$ -	\$11,120
Collectively evaluated for impairment	127,058	242,056	24,812	142,218	132,065	42,219	-	710,428
Total	\$129,444	\$249,526	\$25,516	\$142,425	\$132,418	\$42,219	\$ -	\$721,548
December 31, 2014								
Allowance for loan losses:								
Individually evaluated for impairment	\$51	\$ 331	\$ 1	\$ -	\$1	\$ -	\$ -	\$384
Collectively evaluated for impairment	1,721	4,332	664	2,104	1,672	598	45	11,136
Total	\$1,772	\$4,663	\$ 665	\$2,104	\$1,673	\$ 598	\$ 45	\$11,520
Loans receivable:								
Individually evaluated for impairment	\$2,487	\$6,660	\$ 256	\$ 32	\$361	\$ -	\$ -	\$9,796
Collectively evaluated for	120,345	226,813	18,579	132,025	121,731	40,205	-	659,698

impairment

Total	\$122,832	\$233,473	\$18,835	\$132,057	\$122,092	\$40,205	\$-	\$669,494
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Credit Quality Indicators – Commercial Loans

Management continuously monitors the credit quality of the Company's commercial loans by regularly reviewing certain credit quality indicators. Management utilizes credit risk ratings as the key credit quality indicator for evaluating the credit quality of the Company's loan receivables.

The Company's commercial loan classification and credit grading processes are part of the lending, underwriting, and credit administration functions to ensure an ongoing assessment of credit quality. Accurate and timely loan classification and credit grading is a critical component of loan portfolio management. Loan officers are required to review their loan portfolio risk ratings regularly for accuracy. The loan review function uses the same risk rating system in the loan review process. Quarterly, the Company engages an independent third party to assess the quality of the loan portfolio and evaluate the accuracy of ratings with the loan officer's and management's assessment.

A formal loan classification and credit grading system reflects the risk of default and credit losses. A written description of the risk ratings is maintained that includes a discussion of the factors used to assign appropriate classifications of credit grades to loans. The process identifies groups of loans that warrant the special attention of management. The risk grade groupings provide a mechanism to identify risk within the loan portfolio and provide management and the Board with periodic reports by risk category. The credit risk ratings play an important role in the establishment and evaluation of the provision for loan and lease losses and the ALLL. After determining the historical loss factor which is adjusted for qualitative and environmental factors for each portfolio segment, the portfolio segment balances that have been collectively evaluated for impairment are multiplied by the general reserve loss factor for the respective portfolio segments to determine the general reserve. Loans that have an internal credit rating of special mention or substandard follow the same process; however, the qualitative and environmental factors are further adjusted for the increased risk.

The Company utilizes a loan rating system that assigns a degree of risk to commercial loans based on relevant information about the ability of borrowers to service their debt such as: current financial information, historical payment experience, credit documentation, public information and current economic trends, among other factors. Management analyzes these non-homogeneous loans individually by grading the loans as to credit risk and probability of collection for each type of loan. Commercial loans include commercial indirect auto loans which are not individually risk rated, and construction, land acquisition and development loans include residential construction loans which are also not individually risk rated. These loans are monitored on a pool basis due to their homogeneous nature as described in "Credit Quality Indicators – Other Loans" below. The Company risk rates certain residential real estate loans and consumer loans that are part of a larger commercial relationship using its credit grading system as described in "Credit Quality Indicators – Commercial Loans." The grading system contains the following basic risk categories:

1. Minimal Risk
2. Above Average Credit Quality
3. Average Risk
4. Acceptable Risk
5. Pass - Watch
6. Special Mention
7. Substandard - Accruing
8. Substandard - Non-Accrual
9. Doubtful
10. Loss

This analysis is performed on a quarterly basis using the following definitions for risk ratings:

Pass - Assets rated 1 through 5 are considered pass ratings. These assets show no current or potential problems and are considered fully collectible. All such loans are considered collectively for ALLL calculation purposes. However, accruing TDRs that have been performing for an extended period of time, do not represent a higher risk of loss, and have been upgraded to a pass rating are evaluated individually for impairment.

Special Mention – Assets classified as special mention assets do not currently expose the Company to a sufficient degree of risk to warrant an adverse classification but do possess credit deficiencies or potential weaknesses deserving close attention. Special Mention assets have a potential weakness or pose an unwarranted financial risk which, if not corrected, could weaken the asset and increase risk in the future.

Substandard - Assets classified as substandard have well defined weaknesses based on objective evidence, and are characterized by the distinct possibility that the Company will sustain some loss if the deficiencies are not corrected.

Doubtful - Assets classified as doubtful have all of the weaknesses inherent in those classified substandard with the added characteristic that the weaknesses present make collection or liquidation in full highly questionable and improbable based on current circumstances.

Loss - Assets classified as loss are those considered uncollectible and of such little value that their continuance as assets is not warranted.

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Credit Quality Indicators – Other Loans

Certain residential real estate loans, consumer loans, and commercial indirect auto loans are monitored on a pool basis due to their homogeneous nature. Loans that are delinquent 90 days or more are placed on non-accrual status unless the collection of the loan is in process and reasonably assured. The Company utilizes accruing versus non-accrual status as the credit quality indicator for these loan pools. The following tables present the recorded investment in loans receivable by loan category and credit quality indicator at September 30, 2015 and December 31, 2014:

Credit Quality Indicators
September 30, 2015

	Commercial Loans					Subtotal Commercial	Other Loans		Subtotal Other	Total Loans
	Pass	Special Mention	Substandard	Doubtful	Loss		Accruing Loans	Non-accrual Loans		
Residential real estate	\$21,120	\$405	\$993	\$ -	\$ -	\$22,518	\$106,411	\$515	\$106,926	\$129,444
Commercial real estate	224,342	13,371	11,813	-	-	249,526	-	-	-	249,526
Construction, land acquisition and development	18,157	362	6,068	-	-	24,587	929	-	929	25,516
Commercial and industrial	134,970	935	2,399	-	-	138,304				