C & F FINANCIAL CORP
Form 10-Q
August 08, 2013

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 June 30, 2013

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

For the transition period from to

Commission File Number: 000-23423

C&F Financial Corporation

(Exact name of registrant as specified in its charter)

Virginia	**54-1680165**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**
802 Main Street West Point, VA	**23181**
(Address of principal executive offices)	**(Zip Code)**

(804) 843-2360

(Registrant's telephone number, including area code)

N/A

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

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

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

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

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

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

At August 1, 2013, the latest practicable date for determination, 3,310,792 shares of common stock, $1.00 par value, of the registrant were outstanding.

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PART I - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

CONSOLIDATED BALANCE SHEETS

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

	June 30, 2013 (Unaudited)	December 31, 2012
ASSETS		
Cash and due from banks	**$ 7,830**	$ 8,079
Interest-bearing deposits in other banks	**52,003**	17,541
Total cash and cash equivalents	**59,833**	25,620
Securities-available for sale at fair value, amortized cost of $144,223 and $143,661, respectively	**147,588**	152,817
Loans held for sale at fair value and lower of cost or market, respectively	**59,312**	72,727
Loans, net of allowance for loan losses of $34,769 and $35,907, respectively	**638,557**	640,283
Federal Home Loan Bank stock, at cost	**3,525**	3,744
Corporate premises and equipment, net	**27,852**	27,083
Other real estate owned, net of valuation allowance of $4,245 and $3,937, respectively	**3,925**	6,236
Accrued interest receivable	**5,545**	5,673
Goodwill	**10,724**	10,724
Other assets	**35,820**	32,111
Total assets	**$ 992,681**	$ 977,018
LIABILITIES AND SHAREHOLDERS' EQUITY		
Deposits		
Noninterest-bearing demand deposits	**$ 117,501**	$ 105,721
Savings and interest-bearing demand deposits	**295,366**	293,854
Time deposits	**280,930**	286,609
Total deposits	**693,797**	686,184
Short-term borrowings	**13,531**	9,139
Long-term borrowings	**132,987**	132,987
Trust preferred capital notes	**20,620**	20,620
Accrued interest payable	**786**	837
Other liabilities	**25,160**	25,054
Total liabilities	**886,881**	874,821
Commitments and contingent liabilities	**—**	—

Shareholders’ equity		
Common stock ($1.00 par value, 8,000,000 shares authorized, 3,291,434 and 3,259,823 shares issued and outstanding, respectively)	**3,185**	3,162
Additional paid-in capital	**6,595**	5,624
Retained earnings	**94,979**	88,695
Accumulated other comprehensive income, net	**1,041**	4,716
Total shareholders’ equity	**105,800**	102,197
Total liabilities and shareholders’ equity	**$ 992,681**	$ 977,018

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

CONSOLIDATED STATEMENTS OF INCOME

(Unaudited)

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	**2012**	**2013**	**2012**
Interest income				
Interest and fees on loans	**$17,918**	$17,824	**$35,737**	$35,300
Interest on money market investments	**38**	5	**61**	13
Interest and dividends on securities				
U.S. government agencies and corporations	**100**	52	**206**	109
Tax-exempt obligations of states and political subdivisions	**1,136**	1,186	**2,278**	2,373
Corporate bonds and other	**38**	31	**71**	59
Total interest income	**19,230**	19,098	**38,353**	37,854
Interest expense				
Savings and interest-bearing deposits	**186**	197	**405**	450
Certificates of deposit, $100 or more	**354**	547	**729**	1,187
Other time deposits	**468**	637	**953**	1,361
Borrowings	**885**	967	**1,766**	1,940
Trust preferred capital notes	**189**	248	**377**	497
Total interest expense	**2,082**	2,596	**4,230**	5,435
Net interest income	**17,148**	16,502	**34,123**	32,419
Provision for loan losses	**3,120**	2,860	**6,300**	5,585
Net interest income after provision for loan losses	**14,028**	13,642	**27,823**	26,834
Noninterest income				
Gains on sales of loans	**3,577**	1,631	**5,278**	2,962
Service charges on deposit accounts	**996**	825	**1,920**	1,626
Other service charges and fees	**1,472**	1,608	**2,976**	2,976
Net gains on calls of available for sale securities	**4**	8	**6**	8
Other income	**914**	570	**1,881**	1,681
Total noninterest income	**6,963**	4,642	**12,061**	9,253
Noninterest expenses				
Salaries and employee benefits	**8,229**	6,509	**15,298**	13,479
Occupancy expenses	**1,770**	1,677	**3,538**	3,398
Other expenses	**4,549**	3,954	**8,741**	7,548
Total noninterest expenses	**14,548**	12,140	**27,577**	24,425

Income before income taxes	**6,443**	6,144	**12,307**	11,662
Income tax expense	**2,265**	1,963	**4,123**	3,701
Net income	**4,178**	4,181	**8,184**	7,961
Effective dividends on preferred stock	**—**	165	**—**	311
Net income available to common shareholders	**$4,178**	$4,016	**$8,184**	$7,650
Per common share data				
Net income – basic	**$1.28**	$1.25	**$2.50**	$2.39
Net income – assuming dilution	**$1.22**	$1.22	**$2.41**	$2.33
Cash dividends declared	**$0.29**	$0.26	**$0.58**	$0.52
Weighted average number of shares – basic	**3,276,039**	3,208,792	**3,271,376**	3,199,655
Weighted average number of shares – assuming dilution	**3,413,052**	3,296,145	**3,392,165**	3,280,560

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

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited)

(In thousands)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	**2012**	**2013**	**2012**
Net income	**$4,178**	$4,181	$**8,184**	$7,961
Other comprehensive income (loss), net:				
Changes in defined benefit plan assets and benefit obligations				
Changes in net loss arising during the period[1]	**31**	26	**61**	52
Tax effect[1]	**(11)**	(11)	**(21)**	(19)
Amortization of prior service cost arising during the period[1]	**(17)**	(17)	**(34)**	(34)
Tax effect1	**6**	7	**12**	13
Net of tax amount	**9**	5	**18**	12
Unrealized gain (loss) on cash flow hedging instruments				
Unrealized holding gain (loss) arising during the period	**67**	(33)	**116**	(28)
Tax effect	**(26)**	14	**(45)**	12
Net of tax amount	**41**	(19)	**71**	(16)
Unrealized holding (losses) gains on securities				
Unrealized holding (losses) gains arising during the period	**(4,960)**	1,208	**(5,785)**	1,401
Tax effect	**1,736**	(423)	**2,025**	(491)
Reclassification adjustment for gains included in net income[2]	**(4)**	(8)	**(6)**	(8)
Tax effect	**1**	3	**2**	3
Net of tax amount	**(3,227)**	780	**(3,764)**	905
Other comprehensive income (loss), net:	**(3,177)**	766	**(3,675)**	901
Comprehensive income, net	$**1,001**	$4,947	$**4,509**	$8,862

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[1] These items are included in the computation of net periodic benefit cost. See Note 6, Employee Benefit Plans, for additional information.

[2] Gains are included in "Net gains on calls of available for sale securities" on the income statement.

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

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CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

(Unaudited)

(In thousands, except per share amounts)

	Preferred Stock	Common Stock	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income, Net	Total Shareholders' Equity
Balance December 31, 2012	**$ —**	**$ 3,162**	**$ 5,624**	**$ 88,695**	**$ 4,716**	**$ 102,197**
Comprehensive income:						
Net income	**—**	**—**	**—**	**8,184**	**—**	**8,184**
Other comprehensive (loss) , net	**—**	**—**	**—**	**—**	**(3,675)**	**(3,675)**
Stock options exercised	**—**	**17**	**646**	**—**	**—**	**663**
Share-based compensation	**—**	**—**	**289**	**—**	**—**	**289**
Restricted stock vested	**—**	**5**	**(5)**	**—**	**—**	**—**
Common stock issued	**—**	**1**	**41**	**—**	**—**	**42**
Cash dividends paid – common stock ($0.58 per share)	**—**	**—**	**—**	**(1,900)**	**—**	**(1,900)**
Balance June 30, 2013	**$ —**	**$ 3,185**	**$ 6,595**	**$ 94,979**	**$ 1,041**	**$ 105,800**

	Preferred Stock	Common Stock	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income, Net	Total Shareholders' Equity
Balance December 31, 2011	$ 10	$ 3,091	$ 13,438	$ 76,167	$ 3,384	$ 96,090
Comprehensive income:						
Net income	—	—	—	7,961	—	7,961
Other comprehensive income, net	—	—	—	—	901	901
Stock options exercised	—	23	478	—	—	501
Share-based compensation	—	—	242	—	—	242
Restricted stock vested	—	3	(3)	—	—	—
Preferred stock redemption	(10)	—	(9,990)	—	—	(10,000)
Accretion of preferred stock discount	—	—	172	(172)	—	—
Common stock issued	—	3	78	—	—	81
	—	—	—	(1,668)	—	(1,668)

Cash dividends paid – common stock ($0.52 per share)						
Cash dividends paid – preferred stock (5% per annum)	—	—	—	(203)	—	(203)
Balance June 30, 2012	$ —	$ 3,120	$ 4,415	$ 82,085	$ 4,285	$ 93,905

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

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CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

(In thousands)

	Six Months Ended June 30, 2013	2012
Operating activities:		
Net income	**$8,184**	$7,961
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	**1,128**	1,119
Provision for loan losses	**6,300**	5,585
Provision for indemnifications	**375**	455
Provision for other real estate owned losses	**308**	350
Share-based compensation	**289**	242
Accretion of discounts and amortization of premiums on securities, net	**335**	366
Net realized gain on calls of securities	**(6)**	(8)
Realized (gain) losses on sales of other real estate owned	**(115)**	13
Proceeds from sales of loans held for sale	**403,617**	370,848
Origination of loans held for sale	**(390,202)**	(379,957)
Change in other assets and liabilities:		
Accrued interest receivable	**128**	(118)
Other assets	**(1,736)**	(440)
Accrued interest payable	**(51)**	(137)
Other liabilities	**(126)**	(2,423)
Net cash provided by operating activities	**28,428**	3,856
Investing activities:		
Proceeds from maturities, calls and sales of securities available for sale	**15,357**	21,074
Purchases of securities available for sale	**(16,248)**	(16,682)
Redemption of Federal Home Loan Bank stock	**219**	18
Net increase in customer loans	**(4,644)**	(23,660)
Other real estate owned improvements	**—**	(205)
Proceeds from sales of other real estate owned	**2,188**	1,103
Purchases of corporate premises and equipment, net	**(1,897)**	(660)
Net cash used in investing activities	**(5,025)**	(19,012)
Financing activities:		
Net increase in demand, interest-bearing demand and savings deposits	**13,292**	26,717
Net decrease in time deposits	**(5,679)**	(15,686)
Net increase in borrowings	**4,392**	14,839
Proceeds from exercise of stock options	**663**	501
Issuance of common stock	**42**	81
Redemption of preferred stock	**—**	(10,000)

Cash dividends	**(1,900)**	(1,871)
Net cash provided by financing activities	**10,810**	14,581
Net increase (decrease) in cash and cash equivalents	**34,213**	(575)
Cash and cash equivalents at beginning of period	**25,620**	11,507
Cash and cash equivalents at end of period	**$59,833**	$10,932
Supplemental disclosure		
Interest paid	**$4,281**	$5,572
Income taxes paid	**3,034**	4,918
Supplemental disclosure of noncash investing and financing activities		
Unrealized (losses) gains on securities available for sale	**$(5,791)**	$1,393
Loans transferred to other real estate owned	**(70)**	(438)
Pension adjustment	**27**	18
Unrealized gain (loss) on cash flow hedging instrument	**116**	(28)

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

NOTE 1: Summary of Significant Accounting Policies

Principles of Consolidation: The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP) for interim financial reporting and with applicable quarterly reporting regulations of the Securities and Exchange Commission (the SEC). They do not include all of the information and notes required by U.S. GAAP for complete financial statements. Therefore, these consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the C&F Financial Corporation Annual Report on Form 10-K for the year ended December 31, 2012.

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

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

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

Business segment data is presented in Note 8.

Basis of Presentation: The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, the allowance for indemnifications, impairment of loans, impairment of securities, the valuation of other real estate owned, the projected benefit obligation under the defined benefit pension plan, the valuation of deferred taxes, fair value measurements and goodwill impairment. In the opinion of management, all adjustments, consisting only of normal recurring adjustments, which are necessary for a fair presentation of the results of operations in these financial statements, have been made.

Reclassification: Certain reclassifications have been made to prior period amounts to conform to the current period presentation.

Derivative Financial Instruments: The Corporation recognizes derivative financial instruments at fair value as either an other asset or an other liability in the consolidated balance sheet. The Corporation’s derivative financial instruments as of June 30, 2013 consisted of (1) the fair value of interest rate lock commitments (IRLCs) on mortgage loans that will be sold in the secondary market and the related forward commitments to sell mortgage loans and mortgage-backed securities (MBS) and (2) interest rate swaps that qualified as cash flow hedges of a portion of the Corporation's trust preferred capital notes. Adjustments to reflect unrealized gains and losses resulting from changes in fair value of the Corporation's IRLCs and forward sales commitments and realized gains and losses upon ultimate sale of the loans are classified as noninterest income. The Corporation's IRLCs and forward loan sales commitments are described more fully in Note 7 and Note 9. The effective portion of the gain or loss on the Corporation's cash flow hedges is reported as a component of other comprehensive income, net of deferred income taxes, and reclassified into earnings in the same period or period(s) during which the hedged transaction affects earnings. The cash flow hedges are described more fully in Note 10.

Share-Based Compensation: Compensation expense for the second quarter and first six months of 2013 included expense, net of forfeitures, of $149,000 ($92,000 after tax) and $289,000 ($179,000 after tax), respectively, for restricted stock granted since 2008. As of June 30, 2013, there was $2.32 million of total unrecognized compensation expense related to unvested restricted stock that will be recognized over the remaining requisite service periods.

A summary of activity for restricted stock awards during the first six months of 2013 is presented below:

	Shares	Weighted-Average Grant Date Fair Value
Unvested, January 1, 2013	97,700	$ 24.69
Granted	15,250	$ 44.38
Vested	(5,400)	$ 20.02
Cancelled	(1,400)	$ 27.00
Unvested, June 30, 2013	106,150	$ 27.79

Stock option activity during the six months ended June 30, 2013 and stock options outstanding at June 30, 2013 are summarized below:

	Shares	Exercise Price*	Remaining Contractual Life (in years)*	Intrinsic Value of Unexercised In-The Money

				Options (in 000's)
Options outstanding at January 1, 2013	276,432	$ 39.14	2.30	
Exercised	(16,732)	39.58		
Expired	(13,500)	40.50		
Options outstanding and exercisable at June 30, 2013	246,200	$ 39.03	1.77	$ 4,111

*Weighted average

At the 2013 Annual Meeting of Shareholders of the Corporation held on April 16, 2013 (the Annual Meeting), the Corporation's shareholders approved the C&F Financial Corporation 2013 Stock and Incentive Compensation Plan (the 2013 Plan), which was approved by the Corporation's Board of Directors on February 27, 2013, subject to shareholder approval. The 2013 Plan, which became effective upon shareholder approval at the Annual Meeting, replaces the Amended and Restated C&F Financial Corporation 2004 Incentive Stock Plan (the 2004 Plan). Awards previously granted under the 2004 Plan will remain outstanding in accordance with their terms, but no new awards will be granted under the 2004 Plan following the Annual Meeting. A detailed description of the 2013 Plan is contained in, and the full text of the 2013 Plan is included as Appendix A to, the Corporation's definitive proxy statement on Schedule 14A filed with the Securities and Exchange Commission (SEC) on March 15, 2013 in connection with the Annual Meeting, both of which are incorporated herein by reference.

Recent Significant Accounting Pronouncements:

In February 2013, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2013-02, *Comprehensive Income - Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income.* The amendments in this ASU require an entity to present (either on the face of the statement where net income is presented or in the notes) the effects on the line items of net income of significant amounts reclassified out of accumulated other comprehensive income. In addition, the amendments require a cross-reference to other disclosures currently required for other reclassification items to be reclassified directly to net income in their entirety in the same reporting period. An entity is required to apply these amendments for fiscal years, and interim periods within those years, beginning on or after December 15, 2012. The Corporation has included the required disclosures from ASU 2013-02 in the Corporation's financial statements.

In July 2012, the FASB issued ASU 2012-02, *Intangibles - Goodwill and Other - Testing Indefinite-Lived Intangible Assets for Impairment*. The amendments in this ASU apply to all entities that have indefinite-lived intangible assets, other than goodwill, reported in their financial statements. The amendments in this ASU provide an entity with the option to make a qualitative assessment about the likelihood that an indefinite-lived intangible asset is impaired to determine whether it should perform a quantitative impairment test. The amendments also enhance the consistency of impairment testing guidance among long-lived asset categories by permitting an entity to assess qualitative factors to determine whether it is necessary to calculate the asset's fair value when testing an indefinite-lived intangible asset for impairment. The amendments are effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012. The adoption of ASU 2012-02 did not have a material effect on the Corporation's financial statements.

In December 2011, the FASB issued ASU 2011-11, *Balance Sheet - Disclosures about Offsetting Assets and Liabilities*. This ASU requires entities to disclose both gross information and net information about both instruments and transactions eligible for offset in the balance sheet and instruments and transactions subject to an agreement similar to a master netting arrangement. An entity is required to apply the amendments for annual reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods. An entity should provide the disclosures required by those amendments retrospectively for all comparative periods presented. The adoption of ASU 2011-11 did not have a material effect on the Corporation's financial statements.

In January 2013, the FASB issued ASU 2013-01, *Balance Sheet - Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities.* The amendments in this ASU clarify the scope for derivatives accounted for in accordance with Topic 815, Derivatives and Hedging, including bifurcated embedded derivatives, repurchase agreements and reverse repurchase agreements and securities borrowing and securities lending transactions that are either offset or subject to netting arrangements. An entity is required to apply the amendments for fiscal years, and interim periods within those years, beginning on or after January 1, 2013. The adoption of ASU 2013-01 did not have a material effect on the Corporation’s consolidated financial statements.

NOTE 2: Securities

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

	June 30, 2013			
(Dollars in thousands)	**Amortized**	**Gross**	**Gross**	**Estimated**

	Cost	Unrealized Gains	Unrealized Losses	Fair Value
U.S. government agencies and corporations	**$23,069**	**$ 2**	**$ (1,312)**	**$21,759**
Mortgage-backed securities	**3,222**	**33**	**(100)**	**3,155**
Obligations of states and political subdivisions	**117,905**	**5,058**	**(547)**	**122,416**
Preferred stock	**27**	**231**	**—**	**258**
	$144,223	**$ 5,324**	**$ (1,959)**	**$147,588**

(Dollars in thousands)	December 31, 2012 Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
U.S. government agencies and corporations	$24,628	$ 24	$ (3)	$24,649
Mortgage-backed securities	2,127	62	—	2,189
Obligations of states and political subdivisions	116,879	9,069	(73)	125,875
Preferred stock	27	77	—	104
	$143,661	$ 9,232	$ (76)	$152,817

The amortized cost and estimated fair value of securities, all of which were classified as available for sale, at June 30, 2013, by the earlier of contractual maturity or expected maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to prepay obligations with or without call or prepayment penalties.

	June 30, 2013	
(Dollars in thousands)	**Amortized Cost**	**Estimated Fair Value**
Due in one year or less	**$28,829**	**$ 28,338**
Due after one year through five years	**39,349**	**40,738**
Due after five years through ten years	**49,852**	**50,997**
Due after ten years	**26,166**	**27,257**
Preferred stock	**27**	**258**
	$144,223	**$ 147,588**

Proceeds from the maturities, calls and sales of securities available for sale for the six months ended June 30, 2013 were $15.36 million.

The Corporation pledges securities primarily as collateral for public deposits and repurchase agreements. Securities with an aggregate amortized cost of $110.37 million and an aggregate fair value of $113.03 million were pledged at June 30, 2013. Securities with an aggregate amortized cost of $107.87 million and an aggregate fair value of $115.14 million were pledged at December 31, 2012.

Securities in an unrealized loss position at June 30, 2013, by duration of the period of the unrealized loss, are shown below.

	Less Than 12 Months		**12 Months or More**		**Total**	
(Dollars in thousands)	**Fair Value**	**Unrealized Loss**	**Fair Value**	**Unrealized Loss**	**Fair Value**	**Unrealized Loss**

U.S. government agencies and corporations	**$20,628**	**$ 1,312**	**$—**	**$ —**	**$20,628**	**$ 1,312**
Mortgage backed securities	**2,080**	**100**	**—**	**—**	**2,080**	**100**
Obligations of states and political subdivisions	**13,051**	**511**	**816**	**36**	**13,867**	**547**
Total temporarily impaired securities	**$35,759**	**$ 1,923**	**$816**	**$ 36**	**$36,575**	**$ 1,959**

There are 88 debt securities with fair values totaling $36.6 million considered temporarily impaired at June 30, 2013. The primary cause of the temporary impairments in the Corporation's investments in debt securities was fluctuations in interest rates. During the second quarter of 2013, the municipal bond sector, which is included in the Corporation's obligations of states and political subdivisions category of securities, and securities of U.S. government agencies and corporations experienced falling securities prices as improvement in select U.S. economic indicators and statements made by certain Federal Reserve officials raised concerns that the Federal Reserve would reduce its efforts to stimulate economic recovery through its bond-buying program known as "quantitative easing." Interest rates rose during the second quarter of 2013, causing corresponding unrealized losses on the Corporation's portfolio of securities of U.S. government agencies and corporations and obligations of states and political subdivisions. The vast majority of the Corporation's municipal bond portfolio is made up of securities where the issuing municipalities have unlimited taxing authority to support their debt service obligations. At June 30, 2013, approximately 97 percent of the Corporation's obligations of states and political subdivisions, as measured by market value, were rated “A” or better by Standard & Poor's or Moody's Investors Service. Of those in a net unrealized loss position, approximately 96 percent were rated, as measured by market value, “A” or better at June 30, 2013. Because the Corporation intends to hold these investments in debt securities to maturity and it is more likely than not that the Corporation will not be required to sell these investments before a recovery of unrealized losses, the Corporation does not consider these investments to be other-than-temporarily impaired at June 30, 2013 and no other-then-temporary impairment has been recognized.

Securities in an unrealized loss position at December 31, 2012, by duration of the period of the unrealized loss, are shown below.

	Less Than 12 Months		12 Months or More		Total	
(Dollars in thousands)	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
U.S. government agencies and corporations	$5,479	$ 3	$—	$ —	$5,479	$ 3
Obligations of states and political subdivisions	5,804	71	263	2	6,067	73
Total temporarily impaired securities	$11,283	$ 74	$263	$ 2	$11,546	$ 76

The Corporation’s investment in Federal Home Loan Bank (FHLB) stock totaled $3.53 million at June 30, 2013 and $3.74 million at December 31, 2012. FHLB stock is generally viewed as a long-term investment and as a restricted investment security, which is carried at cost, because there is no market for the stock, other than the FHLBs or member institutions. Therefore, when evaluating FHLB stock for impairment, its value is based on the ultimate recoverability of the par value rather than by recognizing temporary declines in value. The Corporation does not consider this investment to be other-than-temporarily impaired at June 30, 2013 and no impairment has been recognized. FHLB stock is shown as a separate line item on the balance sheet and is not a part of the available for sale securities portfolio.

NOTE 3: Loans

Major classifications of loans are summarized as follows:

(Dollars in thousands)	June 30, 2013	December 31, 2012
Real estate – residential mortgage	**$151,371**	$ 149,257
Real estate – construction [1]	**5,330**	5,062
Commercial, financial and agricultural [2]	**193,414**	205,052
Equity lines	**33,104**	33,324
Consumer	**5,251**	5,309

Consumer finance	**284,856**	278,186
	673,326	676,190
Less allowance for loan losses	**(34,769)**	(35,907)
Loans, net	**$638,557**	$640,283

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

Consumer loans included $249,000 and $293,000 of demand deposit overdrafts at June 30, 2013 and December 31, 2012, respectively.

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Loans on nonaccrual status were as follows:

(Dollars in thousands)	**June 30, 2013**	**December 31, 2012**
Real estate – residential mortgage	**$2,136**	$ 1,805
Commercial, financial and agricultural:		
Commercial real estate lending	**3,550**	3,426
Land acquisition and development lending	**—**	5,234
Builder line lending	**14**	15
Commercial business lending	**702**	759
Equity lines	**211**	31
Consumer	**188**	191
Consumer finance	**680**	655
Total loans on nonaccrual status	**$7,481**	$ 12,116

The past due status of loans as of June 30, 2013 was as follows:

(Dollars in thousands)	**30-59 Days Past Due**	**60-89 Days Past Due**	**90+ Days Past Due**	**Total Past Due**	**Current**	**Total Loans**	**90+ Days Past Due and Accruing**
Real estate – residential mortgage	**$823**	**$561**	**$1,193**	**$2,577**	**$148,794**	**$151,371**	**$ 106**
Real estate – construction:							
Construction lending	**—**	**—**	**—**	**—**	**3,725**	**3,725**	**—**
Consumer lot lending	**—**	**—**	**—**	**—**	**1,605**	**1,605**	**—**
Commercial, financial and agricultural:							
Commercial real estate lending	**4,864**	**121**	**3,216**	**8,201**	**118,472**	**126,673**	**—**
Land acquisition and development lending	**—**	**—**	**—**	**—**	**19,396**	**19,396**	**—**
Builder line lending	**—**	**—**	**—**	**—**	**12,214**	**12,214**	**—**
Commercial business lending	**19**	**—**	**481**	**500**	**34,631**	**35,131**	**—**
Equity lines	**239**	**106**	**89**	**434**	**32,670**	**33,104**	**—**
Consumer	**71**	**—**	**188**	**259**	**4,992**	**5,251**	**—**
Consumer finance	**9,184**	**1,791**	**680**	**11,655**	**273,201**	**284,856**	**—**
Total	**$15,200**	**$2,579**	**$5,847**	**$23,626**	**$649,700**	**$673,326**	**$ 106**

For the purposes of the above table, “Current” includes loans that are 1-29 days past due. In addition, the above table includes nonaccrual loans that are current of $1.4 million, 30-59 days past due of $78,000, 60-89 days past due of $256,000 and 90+ days past due of $5.8 million.

The past due status of loans as of December 31, 2012 was as follows:

(Dollars in thousands)	**30-59 Days Past Due**	**60-89 Days Past Due**	**90+ Days Past Due**	**Total Past Due**	**Current**	**Total Loans**	**90+ Days Past Due and Accruing**
Real estate – residential mortgage	$1,402	$456	$641	$2,499	$146,758	$149,257	$ —
Real estate – construction:							
Construction lending	—	—	—	—	3,157	3,157	—
Consumer lot lending	—	—	—	—	1,905	1,905	—
Commercial, financial and agricultural:							
Commercial real estate lending	7,650	496	324	8,470	111,177	119,647	—
Land acquisition and development lending	—	—	5,234	5,234	28,903	34,137	—
Builder line lending	—	—	—	—	15,948	15,948	—
Commercial business lending	794	—	40	834	34,486	35,320	—
Equity lines	270	—	22	292	33,032	33,324	—
Consumer	69	—	191	260	5,049	5,309	—
Consumer finance	10,111	2,052	655	12,818	265,368	278,186	—
Total	$20,296	$3,004	$7,107	$30,407	$645,783	$676,190	$ —

For the purposes of the above table, "Current" includes loans that are 1-29 days past due. In addition, the above table includes nonaccrual loans that are current of $1.2 million, 30-59 days past due of $3.4 million, 60-89 days past due of $421,000 and 90+ days past due of $7.1 million.

Impaired loans, which consist solely of troubled debt restructurings (TDRs), and the related allowance at June 30, 2013 were as follows:

(Dollars in thousands)	**Recorded Investment in Loans**	**Unpaid Principal Balance**	**Related Allowance**	**Average Balance-Impaired Loans**	**Interest Income Recognized**

Real estate – residential mortgage	**$ 1,753**	**$ 1,981**	**$ 369**	**$ 2,089**	**$ 49**
Commercial, financial and agricultural:					
Commercial real estate lending	**4,338**	**4,527**	**624**	**4,349**	**82**
Builder line lending	**14**	**17**	**4**	**15**	**—**
Commercial business lending	**801**	**805**	**203**	**807**	**4**
Consumer	**323**	**323**	**48**	**323**	**6**
Total	**$ 7,229**	**$ 7,653**	**$ 1,248**	**$ 7,583**	**$ 141**

Impaired loans, which consist solely of TDRs, and the related allowance at December 31, 2012 were as follows:

(Dollars in thousands)	**Recorded Investment in Loans**	**Unpaid Principal Balance**	**Related Allowance**	**Average Balance-Impaired Loans**	**Interest Income Recognized**
Real estate – residential mortgage	$ 2,230	$ 2,283	$ 433	$ 2,266	$ 124
Commercial, financial and agricultural:					
Commercial real estate lending	7,892	8,190	1,775	8,260	254
Land acquisition and development lending	5,234	5,234	1,432	5,443	236
Builder line lending	—	—	—	1,407	—
Commercial business lending	812	817	112	827	13
Consumer	324	324	49	324	16
Total	$ 16,492	$ 16,848	$ 3,801	$ 18,527	$ 643

Loan modifications that were classified as TDRs during the three and six months ended June 30, 2013 and 2012 were as follows:

	Three Months Ended June 30,			
	2013		**2012**	
(Dollars in thousands)	**Number of Loans**	**Post-Modification Recorded Investment**	**Number of Loans**	**Post-Modification Recorded Investment**
Real estate - residential mortgage - interest reduction	**—**	**$ —**	1	$ 122
Real estate - residential mortgage - interest rate concession	**1**	**89**	—	—
Commercial, financial and agricultural:				
Commercial real estate lending - interest rate concession	**1**	**473**	—	—
Builder line lending - interest rate concession	**1**	**17**	—	—
Commercial business lending - interest rate concession	**—**	**—**	2	373
Total	**3**	**$ 579**	3	$ 495

Six Months Ended June 30,

(Dollars in thousands)	2013 Number of Loans	2013 Post-Modification Recorded Investment	2012 Number of Loans	2012 Post-Modification Recorded Investment
Real estate - residential mortgage - interest reduction	**—**	**$ —**	1	$ 122
Real estate - residential mortgage - interest rate concession	**1**	**89**	—	—
Commercial, financial and agricultural:				
Commercial real estate lending - interest rate concession	**2**	**479**	—	—
Builder line lending - interest rate concession	**1**	**17**	—	—
Commercial business lending - interest rate concession	**—**	**—**	2	373
Consumer – interest reduction	**—**	**—**	1	108
Total	**4**	**$ 585**	4	$ 603

TDR payment defaults during the three and six months ended June 30, 2013 and 2012 were as follows:

	Three Months Ended June 30,			
	2013		**2012**	
(Dollars in thousands)	**Number of Loans**	**Recorded Investment**	**Number of Loans**	**Recorded Investment**
Commercial, financial and agricultural:				
Builder line lending	—	$ —	1	$ 88
Commercial business lending	—	—	3	363
Total	—	$ —	4	$ 451

	Six Months Ended June 30,			
	2013		**2012**	
(Dollars in thousands)	**Number of Loans**	**Recorded Investment**	**Number of Loans**	**Recorded Investment**
Commercial, financial and agricultural:				
Commercial real estate lending	**1**	**$ 3**	—	$ —
Builder line lending	—	—	1	88
Commercial business lending	—	—	3	363
Total	**1**	**$ 3**	4	$ 451

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

NOTE 4: Allowance for Loan Losses

The following table presents the changes in the allowance for loan losses by major classification during the six months ended June 30, 2013.

(Dollars in thousands)	**Real Estate Residential Mortgage**	**Real Estate Construction**	**Commercial, Financial and Agricultural**	**Equity Lines**	**Consumer**	**Consumer Finance**	**Total**
Allowance for loan losses:							
Balance at December 31, 2012	**$ 2,358**	**$ 424**	**$ 9,824**	**$ 885**	**$ 283**	**$ 22,133**	**$ 35,907**
Provision charged to operations	**522**	**50**	**328**	**11**	**149**	**5,240**	**6,300**
Loans charged off	**(475)**	**—**	**(2,270)**	**(37)**	**(228)**	**(6,361)**	**(9,371)**
Recoveries of loans previously charged off	**86**	**—**	**60**	**27**	**79**	**1,681**	**1,933**
Balance at June 30, 2013	**$ 2,491**	**$ 474**	**$ 7,942**	**$ 886**	**$ 283**	**$ 22,693**	**$ 34,769**

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

(Dollars in thousands)	**Real Estate Residential Mortgage**	**Real Estate Construction**	**Commercial, Financial and Agricultural**	**Equity Lines**	**Consumer**	**Consumer Finance**	**Total**
Allowance for loan losses:							
Balance at December 31, 2011	$ 2,379	$ 480	$ 10,040	$ 912	$ 319	$ 19,547	$ 33,677
Provision charged to operations	576	(94)	917	130	76	3,980	5,585
Loans charged off	(638)	—	(402)	(121)	(171)	(4,102)	(5,434)
Recoveries of loans previously charged off	23	—	36	—	99	1,471	1,629
Balance at June 30, 2012	$ 2,340	$ 386	$ 10,591	$ 921	$ 323	$ 20,896	$ 35,457

The following table presents, as of June 30, 2013, the total allowance for loan losses, the allowance by impairment methodology (individually evaluated for impairment or collectively evaluated for impairment), total loans, and loans by impairment methodology (individually evaluated for impairment or collectively evaluated for impairment).

(Dollars in thousands)	Real Estate Residential Mortgage	Real Estate Construction	Commercial, Financial and Agricultural	Equity Lines	Consumer	Consumer Finance	Total
Allowance for loan losses:							
Balance at June 30, 2013	**$ 2,491**	**$ 474**	**$ 7,942**	**$886**	**$ 283**	**$ 22,693**	**$34,769**
Ending balance: individually evaluated for impairment	**$ 443**	**$ —**	**$ 756**	**$—**	**$ 48**	**$—**	**$1,247**
Ending balance: collectively evaluated for impairment	**$ 2,048**	**$ 474**	**$ 7,186**	**$886**	**$ 235**	**$ 22,693**	**$33,522**
Loans:							
Balance at June 30, 2013	**$ 151,371**	**$ 5,330**	**$ 193,414**	**$33,104**	**$ 5,251**	**$ 284,856**	**$673,326**
Ending balance: individually evaluated for impairment	**$ 2,236**	**$ —**	**$ 4,670**	**$—**	**$ 323**	**$—**	**$7,229**
Ending balance: collectively evaluated for impairment	**$ 149,135**	**$ 5,330**	**$ 188,744**	**$33,104**	**$ 4,928**	**$ 284,856**	**$666,097**

The following table presents, as of December 31, 2012, the total allowance for loan losses, the allowance by impairment methodology (individually evaluated for impairment or collectively evaluated for impairment), total loans, and loans by impairment methodology (individually evaluated for impairment or collectively evaluated for impairment).

(Dollars in thousands)	Real Estate Residential Mortgage	Real Estate Construction	Commercial, Financial and Agricultural	Equity Lines	Consumer	Consumer Finance	Total
Allowance for loan losses:							
Balance at December 31, 2012	$ 2,358	$ 424	$ 9,824	$885	$ 283	$ 22,133	$35,907
Ending balance: individually evaluated for impairment	$ 433	$ —	$ 3,319	$—	$ 49	$—	$3,801
	$ 1,925	$ 424	$ 6,505	$885	$ 234	$ 22,133	$32,106

Ending balance: collectively evaluated for impairment							
Loans:							
Balance at December 31, 2012	$ 149,257	$ 5,062	$ 205,052	$ 33,324	$ 5,309	$ 278,186	$ 676,190
Ending balance: individually evaluated for impairment	$ 2,230	$ —	$ 13,938	$ —	$ 324	$ —	$ 16,492
Ending balance: collectively evaluated for impairment	$ 147,027	$ 5,062	$ 191,114	$ 33,324	$ 4,985	$ 278,186	$ 659,698

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Loans by credit quality indicators as of June 30, 2013 were as follows:

(Dollars in thousands)	Pass	Special Mention	Substandard	Substandard Nonaccrual	Total[1]
Real estate – residential mortgage	**$146,091**	**$ 1,441**	**$ 1,703**	**$ 2,136**	**$151,371**
Real estate – construction:					
Construction lending	**796**	**—**	**2,929**	**—**	**3,725**
Consumer lot lending	**1,605**	**—**	**—**	**—**	**1,605**
Commercial, financial and agricultural:					
Commercial real estate lending	**113,991**	**1,033**	**8,099**	**3,550**	**126,673**
Land acquisition and development lending	**17,217**	**1,741**	**438**	**—**	**19,396**
Builder line lending	**10,166**	**1,449**	**585**	**14**	**12,214**
Commercial business lending	**24,930**	**197**	**9,302**	**702**	**35,131**
Equity lines	**31,071**	**1,116**	**706**	**211**	**33,104**
Consumer	**4,692**	**3**	**368**	**188**	**5,251**
	$350,559	**$ 6,980**	**$ 24,130**	**$ 6,801**	**$388,470**

[1] At June 30, 2013, the Corporation did not have any loans classified as Doubtful or Loss.

(Dollars in thousands)	Performing	Non-Performing	Total
Consumer finance	**$ 284,176**	**$ 680**	**$284,856**

Loans by credit quality indicators as of December 31, 2012 were as follows:

(Dollars in thousands)	Pass	Special Mention	Substandard	Substandard Nonaccrual	Total[1]
Real estate – residential mortgage	$143,947	$ 1,374	$ 2,131	$ 1,805	$149,257
Real estate – construction:					
Construction lending	228	—	2,929	—	3,157

Consumer lot lending	1,905	—	—	—	1,905
Commercial, financial and agricultural:					
Commercial real estate lending	102,472	2,776	10,973	3,426	119,647
Land acquisition and development lending	19,422	1,789	7,692	5,234	34,137
Builder line lending	13,469	1,926	538	15	15,948
Commercial business lending	32,330	187	2,044	759	35,320
Equity lines	31,199	1,327	767	31	33,324
Consumer	4,746	3	369	191	5,309
	$349,718	$ 9,382	$ 27,443	$ 11,461	$398,004

[1] At December 31, 2012, the Corporation did not have any loans classified as Doubtful or Loss.

(Dollars in thousands)	**Performing**	**Non-Performing**	**Total**
Consumer finance	$ 277,531	$ 655	$278,186

NOTE 5: Stockholders' Equity and Earnings Per Common Share

Stockholders' Equity - Other Comprehensive Income

The following table presents the cumulative balances of the components of other comprehensive income, net of deferred tax assets of $536,000 and $2.51 million as of June 30, 2013 and December 31, 2012, respectively.

(Dollars in thousands)	**June 30, 2013**	**December 31, 2012**
Net unrealized gains on securities	**$2,187**	$ 5,951
Net unrecognized loss on cash flow hedges	**(242)**	(313)
Net unrecognized losses on defined benefit pension plan	**(904)**	(922)
Total cumulative other comprehensive income	**$1,041**	$ 4,716

Earnings Per Common Share

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

(Dollars in thousands)	**Three Months Ended June 30, 2013**	**2012**
Net income	**$4,178**	$4,181
Accumulated dividends on Series A Preferred Stock	—	(14)
Accretion of Series A Preferred Stock discount	—	(151)
Net income available to common shareholders	**$4,178**	$4,016
Weighted average number of common shares used in earnings per common share – basic	**3,276,039**	3,208,792
Effect of dilutive securities:		
Stock option awards and Warrant	**137,013**	87,353
Weighted average number of common shares used in earnings per common share – assuming dilution	**3,413,052**	3,296,145

(Dollars in thousands)	**Six Months Ended June 30,**	
	2013	**2012**
Net income	**$8,184**	$7,961
Accumulated dividends on Series A Preferred Stock	—	(139)
Accretion of Series A Preferred Stock discount	—	(172)
Net income available to common shareholders	**$8,184**	$7,650
Weighted average number of common shares used in earnings per common share – basic	**3,271,376**	3,199,655
Effect of dilutive securities:		
Stock option awards and Warrant	**120,789**	80,905
Weighted average number of common shares used in earnings per common share – assuming dilution	**3,392,165**	3,280,560

Potential common shares that may be issued by the Corporation for its stock option awards and Warrant (defined below) are determined using the treasury stock method. Approximately 500 and 276,500 shares issuable upon exercise of options were not included in computing diluted earnings per common share for the three months ended June 30, 2013 and 2012, respectively, and approximately 35,100 and 276,500 shares issuable upon exercise of options were not included in computing diluted earnings per common share for the six months ended June 30, 2013 and 2012, respectively, because they were anti-dilutive.

In January 2009, the Corporation issued to the United States Department of the Treasury (Treasury) under the Capital Purchase Program (CPP) $20.00 million of its Fixed Rate Cumulative Perpetual Preferred Stock, Series A (the Preferred Stock) and a warrant to purchase 167,504 shares of the Corporation’s common stock (the Warrant). On July 27, 2011, the Corporation redeemed $10.00 million of the Preferred Stock, and on April 12, 2012, the Corporation redeemed the remaining $10.00 million of the Preferred Stock. As a result of this redemption, the Corporation will pay no future dividends on the Preferred Stock. Further, in connection with this redemption, the Corporation accelerated the accretion of the remaining preferred stock discount during April 2012, which reduced net income available to common shareholders by approximately $151,000.

NOTE 6: Employee Benefit Plan

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

(Dollars in thousands)	**Three Months Ended June 30,**		**Six Months Ended June 30,**	
	2013	2012	**2013**	2012
Service cost	**$194**	$159	**$388**	$318
Interest cost	**107**	99	**213**	198
Expected return on plan assets	**(187)**	(158)	**(374)**	(316)
Amortization of prior service cost	**(17)**	(17)	**(34)**	(34)
Amortization of net loss	**31**	26	**61**	52
Net periodic benefit cost	**$128**	$109	**$254**	$218

NOTE 7: Fair Value of Assets and Liabilities

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

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

- Level 2—Valuation is based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model based valuation techniques for which all significant assumptions are observable in the market or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

- Level 3—Valuation is determined using model-based techniques that use at least one significant assumption not observable in the market. These unobservable assumptions reflect the Corporation's estimates of assumptions that market participants would use in pricing the respective asset or liability. Valuation techniques may include the use of pricing models, discounted cash flow models and similar techniques.

U.S. GAAP allows an entity the irrevocable option to elect fair value (the fair value option) for the initial and subsequent measurement for certain financial assets and liabilities on a contract-by-contract basis. Other than described in this Note 7, the Corporation has not made any fair value option elections.

Assets and Liabilities Measured at Fair Value on a Recurring Basis

The following describes the valuation techniques and inputs used by the Corporation in determining the fair value of certain assets recorded at fair value on a recurring basis in the financial statements.

Securities available for sale. The Corporation primarily values its investment portfolio using Level 2 fair value measurements, but may also use Level 1 or Level 3 measurements if required by the future composition of the portfolio. At June 30, 2013 and December 31, 2012, the Corporation's entire investment securities portfolio was valued using Level 2 fair value measurements. The Corporation has contracted with a third party portfolio accounting service vendor for valuation of its securities portfolio. The vendor's sources for security valuation are Standard & Poor's Securities Evaluations Inc. ("SPSE") and Thomson Reuters Pricing Service ("TRPS"). Both sources provide opinions, known as evaluated prices, as to the value of individual securities based on model-based pricing techniques that are partially based on available market data, including prices for similar instruments in active markets and prices for identical assets in markets that are not active. SPSE provides evaluated prices for the Corporation's obligations of states and political subdivisions category of securities. SPSE uses proprietary pricing models and pricing systems, mathematical tools and judgment to determine an evaluated price for a security based upon a hierarchy of market information regarding that security or securities with similar characteristics. TRPS provides evaluated prices for the Corporation's U.S. government agencies and corporations and mortgage-backed categories of securities. Securities in the U.S. government agencies and corporations category are individually evaluated on an option adjusted spread basis for callable issues or on a nominal spread basis incorporating the term structure of agency market spreads and the appropriate risk free benchmark curve for non-callable issues. Securities in the mortgage-backed category are grouped into aggregate categories defined by issuer program, weighted average coupon, and weighted average maturity. Each aggregate is benchmarked to a relative mortgage-backed to-be-announced ("TBA") price. TBA prices are obtained from market makers and live trading systems.

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Loans held for sale. During the second quarter of 2013, the Corporation elected to begin using fair value accounting for its entire portfolio of loans held for sale (LHFS) in accordance with ASC 820 - *Fair Value Measurement and Disclosures*. Fair value of the Corporation's LHFS is based on observable market prices for the identical instruments traded in the secondary mortgage loan markets in which the Corporation conducts business. The Corporation's portfolio of LHFS is classified as Level 2.

IRLCs. The Corporation recognizes IRLCs at fair value. Fair value of IRLCs is based on either (i) the price of the underlying loans obtained from an investor for loans that will be delivered on a best efforts basis or (ii) the observable price for individual loans traded in the secondary market for loans that will be delivered on a mandatory basis. All of the Corporation's IRLCs are classified as Level 2.

Forward sales commitments. Forward commitments to sell mortgage loans and MBS are used to mitigate interest rate risk for residential mortgage loans held for sale and IRLCs. Forward commitments to sell mortgage loans and MBS are considered derivatives and are recorded at fair value, based on (i) committed sales prices from investors for commitments to sell mortgage loans or (ii) observable market data inputs for commitments to sell MBS. The Corporation's forward sales commitments are classified as Level 2.

Derivative liability - cash flow hedges. The fair value of the Corporation's cash flow hedges is determined using the discounted cash flow method.

The following table presents the balances of financial assets measured at fair value on a recurring basis.

	June 30, 2013 Fair Value Measurements Using			**Assets at Fair**
(Dollars in thousands)	**Level 1**	**Level 2**	**Level 3**	**Value**
Assets:				
Securities available for sale				
U.S. government agencies and corporations	**$—**	**$21,759**	**$ —**	**$21,759**
Mortgage-backed securities	**—**	**3,155**	**—**	**3,155**
Obligations of states and political subdivisions	**—**	**122,416**	**—**	**122,416**
Preferred stock	**—**	**258**	**—**	**258**
Total securities available for sale	**—**	**147,588**	**—**	**147,588**
Loans held for sale	**—**	**59,312**	**—**	**59,312**
Interest rate lock commitments	**—**	**1,011**	**—**	**1,011**
Forward sales commitments	**—**	**303**	**—**	**303**
Total assets	**$—**	**$208,214**	**$ —**	**$208,214**
Liabilities:				
Derivative liability - cash flow hedges	**$—**	**$397**	**$ —**	**$397**

	December 31, 2012 Fair Value Measurements Using			**Assets at Fair**
(Dollars in thousands)	**Level 1**	**Level 2**	**Level 3**	**Value**
Assets:				
Securities available for sale				
U.S. government agencies and corporations	$—	$24,649	$ —	$24,649
Mortgage-backed securities	—	2,189	—	2,189
Obligations of states and political subdivisions	—	125,875	—	125,875
Preferred stock	—	104	—	104
Total securities available for sale	$—	$152,817	$ —	$152,817
Liabilities:				
Derivative liability - cash flow hedges	$—	$513	$ —	$513

Assets and Liabilities Measured at Fair Value on a Nonrecurring Basis

The Corporation may be required, from time to time, to measure and recognize certain other financial assets at fair value on a nonrecurring basis in accordance with GAAP. The following describes the valuation techniques and inputs used by the Corporation in determining the fair value of certain assets recorded at fair value on a nonrecurring basis in the financial statements.

Impaired loans. The Corporation does not record loans held for investment at fair value on a recurring basis. However, there are instances when a loan is considered impaired and an allowance for loan losses is established. A loan is considered impaired when it is probable that the Corporation will be unable to collect all interest and principal payments as scheduled in the loan agreement. All TDRs are considered impaired loans. The Corporation measures impairment on a loan-by-loan basis for commercial, construction and residential loans in excess of $500,000 by either the present value of expected future cash flows discounted at the loan’s effective interest rate, the loan’s obtainable market price, or the fair value of the collateral if the loan is collateral dependent. Additionally, management reviews current market conditions, borrower history, past experience with similar loans and economic conditions. Based on management's review, additional write-downs to fair value may be incurred. The Corporation maintains a valuation allowance to the extent that the measure of the impaired loan is less than the recorded investment. When the fair value of an impaired loan is based solely on observable cash flows, market price or a current appraisal, the Corporation records the impaired loan as nonrecurring Level 2. However, if based on management's review, additional write-downs to fair value are required, the Corporation records the impaired loan as nonrecurring Level 3.

The measurement of impaired loans of less than $500,000 is based on each loan's future cash flows discounted at the loan's effective interest rate rather than the market rate of interest, which is not a fair value measurement and is therefore excluded from fair value disclosure requirements.

Other real estate owned (OREO). Assets acquired through, or in lieu of, loan foreclosure are held for sale and are initially recorded at fair value less costs to sell at the date of foreclosure. Initial fair value is based upon appraisals the Corporation obtains from independent licensed appraisers. Subsequent to foreclosure, management periodically performs valuations of the foreclosed assets based on updated appraisals, general market conditions, recent sales of like properties, length of time the properties have been held, and our ability and intention with regard to continued ownership of the properties. The Corporation may incur additional write-downs of foreclosed assets to fair value less costs to sell if valuations indicate a further other-than-temporary deterioration in market conditions. As such, we record OREO as nonrecurring Level 3.

The following table presents the balances of financial assets measured at fair value on a non-recurring basis.

	June 30, 2013 Fair Value Measurements Using			**Assets at Fair**
(Dollars in thousands)	**Level 1**	**Level 2**	**Level 3**	**Value**
Impaired loans, net	**$—**	**$ —**	**$2,617**	**$2,617**
Other real estate owned, net	**—**	**—**	**3,925**	**3,925**

	December 31, 2012 Fair Value Measurements Using			**Assets at Fair**
(Dollars in thousands)	**Level 1**	**Level 2**	**Level 3**	**Value**
Impaired loans, net	**$—**	**$ —**	**$9,074**	**$9,074**
Other real estate owned, net	**—**	**—**	**6,236**	**6,236**

The following table presents quantitative information about Level 3 fair value measurements for financial assets measured at fair value on a non-recurring basis as of June 30, 2013:

(Dollars in thousands)	**Fair Value Measurements at June 30, 2013** **Fair Value**	**Valuation Technique(s)**	**Unobservable Inputs**	**Range of Inputs**
Impaired loans, net	2,617	Appraisals	Discount to reflect current market conditions and estimated selling costs	5% - 40%
Other real estate owned, net	3,925	Appraisals	Discount to reflect current market conditions and estimated selling costs	0% - 50%

Fair Value of Financial Instruments

FASB ASC 825, *Financial Instruments*, requires disclosure about fair value of financial instruments, including those financial assets and financial liabilities that are not required to be measured and reported at fair value on a recurring or nonrecurring basis. ASC 825 excludes certain financial instruments and all nonfinancial instruments from its disclosure requirements. Accordingly, the aggregate fair value amounts presented may not necessarily represent the underlying fair value of the Corporation.

The following describes the valuation techniques used by the Corporation to measure its financial instruments at fair value as of June 30, 2013 and December 31, 2012.

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

Loans, net. The fair value of performing loans is estimated using a discounted expected future cash flows analysis based on current rates being offered on similar products in the market. An overall valuation adjustment is made for specific credit risks as well as general portfolio risks. Based on the valuation methodologies used in assessing the fair value of loans and the associated valuation allowance, these loans are considered Level 3.

Loan totals, as listed in the table below, include impaired loans. For valuation techniques used in relation to impaired loans, see the Assets and Liabilities Measured at Fair Value on a Nonrecurring Basis section in this Note 7.

Loans held for sale, net. As described in Note 7, the Corporation elected to carry its portfolio of loans held for sale at fair value, measured on a recurring basis, during the second quarter of 2013. Loans held for sale as of December 31, 2012 were carried at the lower of cost or market value. In addition, all loans held for sale as of December 31, 2012 were originated on a best efforts delivery basis. Therefore, as of December 31, 2012, the fair value of loans held for sale was based on purchase prices agreed to by third party investors, which were obtained simultaneously with the rate lock commitments made to individual borrowers.

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

Deposits. The fair value of all demand deposit accounts is the amount payable at the report date. For all other deposits, the fair value is determined using the discounted cash flow method. The discount rate was equal to the rate currently offered on similar products in active markets (Level 2).

Borrowings. The fair value of borrowings is determined using the discounted cash flow method. The discount rate was equal to the rate currently offered on similar products in active markets (Level 2).

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

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

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

The following tables reflect the carrying amounts and estimated fair values of the Corporation's financial instruments whether or not recognized on the balance sheet at fair value.

		Fair Value Measurements at June 30, 2013 Using			
(Dollars in thousands)	Carrying Value	Level 1	Level 2	Level 3	Total Fair Value
Financial assets:					
Cash and short-term investments	$59,833	$59,833	$—	$—	$59,833
Securities available for sale	147,588		147,588		147,588
Loans, net	638,557	—	—	649,453	649,453
Loans held for sale, net	59,312	—	59,312	—	59,312
Derivative assets	1,314	—	1,314	---	1,314
Accrued interest receivable	5,545	5,545	—	—	5,545
Financial liabilities:					
Demand deposits	$412,867	$412,867	$—	$—	$412,867
Time deposits	280,930	—	284,626	—	284,626
Borrowings	167,138	—	159,950	—	159,950
Derivative liability	397	—	397	—	397
Accrued interest payable	786	786	—	—	786

(Dollars in thousands)	Carrying Value	Fair Value Measurements at December 31, 2012 Using Level 1	Level 2	Level 3	Total Fair Value
Financial assets:					
Cash and short-term investments	$25,620	$25,620	$—	$—	$25,620
Securities available for sale	152,817		152,817		152,817
Loans, net	640,283	—	—	651,133	651,133
Loans held for sale, net	72,727	—	74,964	—	74,964
Accrued interest receivable	5,673	5,673	—	—	5,673
Financial liabilities:					
Demand deposits	$399,575	$399,575	$—	$—	$399,575
Time deposits	286,609	—	290,483	—	290,483
Borrowings	162,746	—	158,027	—	158,027
Derivative liability	513		513		513
Accrued interest payable	837	837	—	—	837

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

NOTE 8: Business Segments

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

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

	Three Months Ended June 30, 2013					
(Dollars in thousands)	**Retail Banking**	**Mortgage Banking**	**Consumer Finance**	**Other**	**Eliminations**	**Consolidated**
Revenues:						
Interest income	**$7,783**	**$ 416**	**$ 12,320**	**$1**	**$ (1,290)**	**$ 19,230**
Gains on sales of loans	**—**	**3,577**	**—**	**—**	**—**	**3,577**
Other noninterest income	**1,689**	**1,086**	**276**	**335**	**—**	**3,386**
Total operating income	**9,472**	**5,079**	**12,596**	**336**	**(1,290)**	**26,193**
Expenses:						
Interest expense	**1,473**	**81**	**1,628**	**190**	**(1,290)**	**2,082**
Provision for loan losses	**600**	**30**	**2,490**	**—**	**—**	**3,120**
Salaries and employee benefits	**4,067**	**2,009**	**1,944**	**209**	**—**	**8,229**
Other noninterest expenses	**3,228**	**1,315**	**1,060**	**716**	**—**	**6,319**
Total operating expenses	**9,368**	**3,435**	**7,122**	**1,115**	**(1,290)**	**19,750**
Income (loss) before income taxes	**104**	**1,644**	**5,474**	**(779)**	**—**	**6,443**
Provision for (benefit from) income taxes	**(395)**	**658**	**2,135**	**(133)**	**—**	**2,265**
Net income (loss)	**$499**	**$ 986**	**$ 3,339**	**$(646)**	**$ —**	**$ 4,178**
Total assets	**$843,917**	**$ 75,448**	**$ 286,514**	**$4,054**	**$ (217,252)**	**$ 992,681**
Capital expenditures	**$527**	**$ 30**	**$ 22**	**$—**	**$ —**	**$ 579**

	Three Months Ended June 30, 2012					
(Dollars in thousands)	**Retail Banking**	**Mortgage Banking**	**Consumer Finance**	**Other**	**Eliminations**	**Consolidated**
Revenues:						
Interest income	$8,096	$ 566	$ 11,695	$—	$ (1,259)	$ 19,098
Gains on sales of loans	—	1,631	—	—	—	1,631
Other noninterest income	1,464	979	234	336	(2)	3,011
Total operating income	9,560	3,176	11,929	336	(1,261)	23,740
Expenses:						
Interest expense	1,920	113	1,574	248	(1,259)	2,596
Provision for loan losses	750	30	2,080	—	—	2,860

Salaries and employee benefits	3,742	723	1,846	198	—	6,509
Other noninterest expenses	2,862	1,613	1,051	105	—	5,631
Total operating expenses	9,274	2,479	6,551	551	(1,259)	17,596
Income (loss) before income taxes	286	697	5,378	(215)	(2)	6,144
Provision for (benefit from) income taxes	(332)	278	2,098	(81)	—	1,963
Net income (loss)	$618	$ 419	$ 3,280	$(134)	$ (2)	$ 4,181
Total assets	$791,327	$ 91,025	$ 265,995	$2,974	$ (201,607)	$ 949,714
Capital expenditures	$173	$ 158	$ 41	$—	$ —	$ 372

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(Dollars in thousands)	Six Months Ended June 30, 2013 Retail Banking	Mortgage Banking	Consumer Finance	Other	Eliminations	Consolidated
Revenues:						
Interest income	**$15,599**	**$ 843**	**$ 24,492**	**$1**	**$ (2,582)**	**$ 38,353**
Gains on sales of loans	**—**	**5,278**	**—**	**—**	**—**	**5,278**
Other noninterest income	**3,400**	**2,164**	**574**	**645**	**—**	**6,783**
Total operating income	**18,999**	**8,285**	**25,066**	**646**	**(2,582)**	**50,414**
Expenses:						
Interest expense	**3,017**	**173**	**3,244**	**378**	**(2,582)**	**4,230**
Provision for loan losses	**1,000**	**60**	**5,240**	**—**	**—**	**6,300**
Salaries and employee benefits	**8,209**	**2,754**	**3,934**	**401**	**—**	**15,298**
Other noninterest expenses	**6,253**	**2,744**	**2,174**	**1,108**	**—**	**12,279**
Total operating expenses	**18,479**	**5,731**	**14,592**	**1,887**	**(2,582)**	**38,107**
Income (loss) before income taxes	**520**	**2,554**	**10,474**	**(1,241)**	**—**	**12,307**
Provision for (benefit from) income taxes	**(675)**	**1,022**	**4,085**	**(309)**	**—**	**4,123**
Net income (loss)	**$1,195**	**$ 1,532**	**$ 6,389**	**$(932)**	**$ —**	**$ 8,184**
Total assets	**$843,917**	**$ 75,448**	**$ 286,514**	**$4,054**	**$ (217,252)**	**$ 992,681**
Capital expenditures	**$1,732**	**$ 131**	**$ 41**	**$2**	**$ —**	**$ 1,906**

(Dollars in thousands)	Six Months Ended June 30, 2012 Retail Banking	Mortgage Banking	Consumer Finance	Other	Eliminations	Consolidated
Revenues:						
Interest income	$16,163	$ 1,140	$ 23,034	$—	$ (2,483)	$ 37,854
Gains on sales of loans	—	2,962	—	—	—	2,962
Other noninterest income	3,030	2,095	494	672	—	6,291
Total operating income	19,193	6,197	23,528	672	(2,483)	47,107
Expenses:						
Interest expense	4,078	219	3,124	497	(2,483)	5,435
Provision for loan losses	1,500	105	3,980	—	—	5,585
Salaries and employee benefits	7,748	1,534	3,722	475	—	13,479
Other noninterest expenses	5,771	2,945	1,974	256	—	10,946
Total operating expenses	19,097	4,803	12,800	1,228	(2,483)	35,445
Income (loss) before income taxes	96	1,394	10,728	(556)	—	11,662
Provision for (benefit from) income taxes	(829)	557	4,184	(211)	—	3,701
Net income (loss)	$925	$ 837	$ 6,544	$(345)	$ —	$ 7,961
Total assets	$791,327	$ 91,025	$ 265,995	$2,974	$ (201,607)	$ 949,714
Capital expenditures	$352	$ 209	$ 99	$—	$ —	$ 660

The Retail Banking segment extends a warehouse line of credit to the Mortgage Banking segment, providing a portion of the funds needed to originate mortgage loans. The Retail Banking segment charges the Mortgage Banking segment interest at the daily FHLB advance rate plus 50 basis points. The Retail Banking segment also provides the Consumer Finance segment with a portion of the funds needed to originate loans by means of a variable rate line of credit that carries interest at one-month LIBOR plus 200 basis points and fixed rate loans that carry interest rates ranging from 3.8 percent to 8.0 percent. The Retail Banking segment acquires certain residential real estate loans from the Mortgage Banking segment at prices similar to those paid by third-party investors. These transactions are eliminated to reach consolidated totals. Certain corporate overhead costs incurred by the Retail Banking segment are not allocated to the Mortgage Banking, Consumer Finance and Other segments.

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

C&F Mortgage enters into IRLCs with customers and will sell the underlying loans to investors on either a best efforts or a mandatory basis. C&F Mortgage mitigates interest rate risk on IRLCs and loans held for sale by (a) entering into forward loan sales contracts with investors for loans to be delivered on a best efforts basis or (b) entering into forward sales contracts of MBS for loans to be delivered on a mandatory basis. Both the IRLCs with customers and the forward sales contracts are considered derivative financial instruments. At June 30, 2013, the Corporation had derivative financial instruments with a notional value of $227.1 million. The fair value of these derivative instruments at June 30, 2013 was $1.3 million, which was included in other assets.

C&F Mortgage sells substantially all of the residential mortgage loans it originates to third-party counterparties. As is customary in the industry, the agreements with these counterparties require C&F Mortgage to extend representations and warranties with respect to program compliance, borrower misrepresentation, fraud, and early payment performance. Under the agreements, the counterparties are entitled to make loss claims and repurchase requests of C&F Mortgage for loans that contain covered deficiencies. C&F Mortgage has obtained early payment default recourse waivers for a significant portion of its business. Recourse periods for early payment default for the remaining counterparties vary from 90 days up to one year. Recourse periods for borrower misrepresentation or fraud, or underwriting error do not have a stated time limit. C&F Mortgage maintains an indemnification reserve for potential claims made under these recourse provisions. The following table presents the changes in the allowance for indemnification losses for the periods presented:

	Three Months Ended June 30,		**Six Months Ended June 30,**	
(Dollars in thousands)	**2013**	**2012**	**2013**	**2012**
Allowance, beginning of period	**$2,082**	$1,827	**$2,092**	$1,702
Provision for indemnification losses	**150**	330	**375**	455
Payments	**—**	(500)	**(235)**	(500)
Allowance, end of period	**$2,232**	$1,657	**$2,232**	$1,657

NOTE 10: Interest Rate Swaps

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

The cash flow hedges total notional amount is $10.00 million. At June 30, 2013, the cash flow hedges had a fair value of ($397,000), which is recorded in other liabilities. The cash flow hedges were fully effective at June 30, 2013 and therefore the loss on the cash flow hedges was recognized as a component of other comprehensive income (loss), net of deferred income taxes.

NOTE 11: Other Noninterest Expenses

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

	Three Months Ended June 30,		Six Months Ended June 30,	
(Dollars in thousands)	**2013**	**2012**	**2013**	**2012**
Loan and OREO expenses	**$218**	$306	**$440**	$655
Data processing fees	**651**	563	**1,317**	1,059
Provision for indemnification losses	**150**	330	**375**	455
Telecommunication expenses	**304**	303	**592**	587
Professional fees	**419**	398	**960**	854
Acquisition transaction costs	**581**	—	**782**	—
All other noninterest expenses	**2,226**	2,054	**4,275**	3,938
Total Other Noninterest Expenses	**$4,549**	$3,954	$8,741	$7,548

NOTE 12: Proposed Business Combination

On June 10, 2013, the Corporation announced the signing of a definitive merger agreement pursuant to which the Corporation will acquire Central Virginia Bankshares, Inc. (CVB), the one-bank holding company for Central Virginia Bank, in an all-cash transaction valued at $0.32 per common share, or approximately $855 thousand in the aggregate. In addition, C&F will redeem for $3.35 million all of CVB's preferred stock and warrants issued to the U.S. Treasury under the Capital Purchase Program, which totaled $13.24 million including unpaid dividends as of March 31, 2013. After the acquisition of CVB, the combined company's total assets will approximate $1.35 billion and total deposits will approximate $1.0 billion. The merger agreement has been unanimously approved by the boards of directors of both companies. The transaction is expected to close in the fourth quarter of 2013, pending regulatory approvals, the approval of CVB's shareholders and other customary closing conditions.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Cautionary Statement Regarding Forward-Looking Statements

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

- interest rates, such as the current volatility in yields on U.S. Treasury bonds
- general business conditions, as well as conditions within the financial markets
- general economic conditions, including unemployment levels
- the legislative/regulatory climate, including the Dodd-Frank Act and regulations promulgated thereunder, the Consumer Financial Protection Bureau (CFPB) and the regulatory and enforcement activities of the CFPB and rules promulgated under the Basel III framework
- monetary and fiscal policies of the U.S. Government, including policies of the Treasury and the Federal Reserve Board

- the value of securities held in the Corporation’s investment portfolios
- the quality or composition of the loan portfolios and the value of the collateral securing those loans
- the commercial and residential real estate markets
- the inventory level and pricing of used automobiles
- the level of net charge-offs on loans and the adequacy of our allowance for loan losses
- demand in the secondary residential mortgage loan markets
- the level of indemnification losses related to mortgage loans sold
- demand for loan products
- deposit flows
- the Corporation's ability to close the pending Merger with CVB and generate the anticipated benefits therefrom;
- the strength of the Corporation’s counterparties
- competition from both banks and non-banks
- demand for financial services in the Corporation’s market area
- the Corporation's expansion and technology initiatives
- technology
- reliance on third parties for key services

- accounting principles, policies and guidelines and elections by the Corporation thereunder

These risks are exacerbated by the turbulence over the past several years in the global and United States financial markets. Continued weakness in the global and United States financial markets could further affect the Corporation’s performance, both directly by affecting the Corporation’s revenues and the value of its assets and liabilities, and indirectly by affecting the Corporation’s counterparties and the economy in general. While there are some signs of improvement in the economic environment, there was a prolonged period of volatility and disruption in the markets, and unemployment has risen to, and remains at, high levels. There can be no assurance that these unprecedented developments will not continue to materially and adversely affect our business, financial condition and results of operations, as well as our ability to raise capital for liquidity and business purposes.

Our ability to engage in routine funding transactions could be adversely affected by the actions and commercial soundness of other financial institutions. Financial services institutions are interrelated as a result of trading, clearing, counterparty or other relationships, and we routinely execute transactions with counterparties in the financial industry, including brokers and dealers, commercial banks, and other institutions. As a result, defaults by, or even rumors or questions about defaults by, one or more financial services institutions, or the financial services industry generally, could create another market-wide liquidity crisis similar to that experienced in late 2008 and early 2009 and could lead to losses or defaults by us or by other institutions. There is no assurance that any such losses would not materially adversely affect the Corporation’s results of operations.

There can be no assurance that the actions taken by the federal government and regulatory agencies will alleviate the industry or economic factors that may adversely affect the Corporation’s business and financial performance. Further, many aspects of the Dodd-Frank Act remain subject to rulemaking and will take effect over several years, making it difficult to anticipate the overall effect on the Corporation’s business and financial performance.

These risks and uncertainties, and the risks discussed in more detail in Item 1A, "Risk Factors" of the Corporation's Annual Report on Form 10-K for the year ended December 31, 2012 and in Part II, Item 1A, "Risk Factors" of this Quarterly Report on Form 10-Q, should be considered in evaluating the forward-looking statements contained herein. We caution readers not to place undue reliance on those statements, which speak only as of the date of this report.

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

PROPOSED BUSINESS COMBINATION

Certain statements in this Form 10-Q reference a proposed business combination transaction (the "Merger") in which C&F Financial Corporation would acquire Central Virginia Bankshares, Inc. (or CVB). These statements do not constitute an offer to sell or the solicitation of an offer to buy any securities or a solicitation of any vote or approval. Central Virginia Bankshares, Inc. has mailed a proxy statement to its shareholders in connection with their vote on the proposed transaction. BEFORE MAKING ANY VOTING OR INVESTMENT DECISION REGARDING THE PROPOSED TRANSACTION, SHAREHOLDERS OF CENTRAL VIRGINIA BANKSHARES, INC. ARE URGED TO READ THE PROXY STATEMENT CAREFULLY AND IN ITS ENTIRETY BECAUSE IT WILL CONTAIN IMPORTANT INFORMATION. Shareholders of Central Virginia Bankshares, Inc. may obtain copies of all documents regarding this transaction, free of charge, by accessing Central Virginia Bankshares, Inc.'s website at www.centralvabank.com. These documents may also be obtained, free of charge, from Central Virginia Bankshares, Inc. by requesting them in writing to 2036 New Dorset Road, Powhatan, Virginia 23139.

CRITICAL ACCOUNTING POLICIES

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

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

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

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

Impairment of Securities: Impairment of securities occurs when the fair value of a security is less than its amortized cost. For debt securities, impairment is considered other-than-temporary and recognized in its entirety in net income if either (i) we intend to sell the security or (ii) it is more-likely-than-not that we will be required to sell the security before recovery of its amortized cost basis. If, however, we do not intend to sell the security and it is not more-likely-than-not that we will be required to sell the security before recovery, we must determine what portion of the impairment is attributable to a credit loss, which occurs when the amortized cost basis of the security exceeds the present value of the cash flows expected to be collected from the security. If there is no credit loss, there is no other-than-temporary impairment. If there is a credit loss, other-than-temporary impairment exists, and the credit loss must be recognized in net income and the remaining portion of impairment must be recognized in other comprehensive income. For equity securities, impairment is considered to be other-than-temporary based on our ability and intent to hold the investment until a recovery of fair value. Other-than-temporary impairment of an equity security results in a write-down that must be included in net income. We regularly review each investment security for other-than-temporary impairment based on criteria that includes the extent to which cost exceeds market price, the duration of that market decline, the financial health of and specific prospects for the issuer, our best estimate of the present value of cash flows expected to be collected from debt securities, our intention with regard to holding the security to maturity and the likelihood that we would be required to sell the security before recovery.

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

Goodwill: All of the Corporation's goodwill was recognized in connection with the Bank's acquisition of C&F Finance Company in September 2002. With the adoption of Accounting Standards Update 2011-08, *Intangible-Goodwill and Other-Testing Goodwill for Impairment*, in 2012, the Corporation is no longer required to perform a test for impairment unless, based on an assessment of qualitative factors related to goodwill, we determine that it is more likely than not that the fair value of C&F Finance Company is less than its carrying amount. If the likelihood of impairment is more than 50 percent, the Corporation must perform a test for impairment and we may be required to record impairment charges. In assessing the recoverability of the Corporation’s goodwill, major assumptions used in determining impairment are increases in future income, sales multiples in determining terminal value and the discount rate applied to future cash flows. As part of any impairment test, we will perform a sensitivity analysis by increasing the discount rate, lowering sales multiples and reducing increases in future income.

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

Derivative Financial Instruments: The Corporation recognizes derivative financial instruments at fair value as either an other asset or other liability in the consolidated balance sheet. The Corporation's derivative financial instruments consist of (1) the fair value of interest rate lock commitments (IRLCs) on mortgage loans that will be held for sale and related forward sale commitments and (2) interest rate swaps that qualify as cash flow hedges of a portion of the Corporation's trust preferred capital notes. Because the IRLCs and forward sale commitments are not designated as hedging instruments, adjustments to reflect unrealized gains and losses resulting from changes in fair value of the Corporation's IRLCs and forward sales commitments and realized gains and losses upon ultimate sale of the loans are classified as noninterest income. The effective portion of the gain or loss on the Corporation's cash flow hedges is reported as a component of other comprehensive income, net of deferred taxes, and reclassified into earnings in the same period or periods during which the hedged transactions affect earnings. For more information concerning fair value measurements of these instruments, see Part I, Item 1, "Financial Statements" in this Quarterly Report on Form 10-Q under the heading "Note 7: Fair Value of Assets and Liabilities."

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

For further information concerning accounting policies, refer to Item 8, "Financial Statements and Supplementary Data," under the heading "Note 1: Summary of Significant Accounting Policies" in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2012.

OVERVIEW

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

On June 10, 2013, the Corporation announced the signing of a definitive merger agreement pursuant to which the Corporation will acquire Central Virginia Bankshares, Inc. (or CVB), the one-bank holding company for Central Virginia Bank. For more information on this pending acquisition, see Part I, Item I, "Financial Statements" in this Quarterly Report on Form 10-Q under the heading "Note 12: Proposed Business Combination" and the Corporation's Current Report on Form 8-K filed with the SEC on June 14, 2013.

Financial Performance Measures

Net income for the Corporation was $4.2 million for the three months ended June 30, 2013, which was the same as the three months ended June 30, 2012. Net income for the Corporation was $8.2 million for the first six months of 2013, compared with $8.0 million for the first six months of 2012. Net income available to common shareholders was $4.2 million, or $1.22 per common share assuming dilution, for the three months ended June 30, 2013, compared with $4.0 million, or $1.22 per common share assuming dilution, for the three months ended June 30, 2012. Net income available to common shareholders was $8.2 million, or $2.41 per common share assuming dilution for the first half of 2013, compared with $7.7 million, or $2.33 per common share assuming dilution for the first half of 2012. The difference between reported net income and net income available to common shareholders for 2012 is a result of the Preferred Stock dividends and amortization of the Warrant related to the Corporation’s participation in the CPP. In April 2012, the Corporation redeemed the remainder of the Preferred Stock issued in January 2009 under the CPP.

The Corporation’s earnings for the second quarter of and first half of 2013 were attributable to profitability at all three of its principal business segments. The Consumer Finance segment continued to benefit from (1) sustained loan growth and (2) the low funding costs on its variable-rate borrowings. The Mortgage Banking segment benefited from the favorable effects of higher loan production and lower provisions for indemnification losses, as well as the effect of electing to use fair value accounting for loans held for sale and interest rate lock commitments, and for forward sales commitments that are used to hedge the effect of changes in interest rates on loans that are to be sold in the secondary market. The Retail Banking segment benefited from the effects of (1) the continued low interest rate environment on the cost of deposits and the renewal rates on borrowings from the Federal Home Loan Bank, (2) lower provisions for loan losses and (3) increased activity-based interchange and overdraft fee income.

The Corporation’s ROE and ROA were 15.65 percent and 1.69 percent, respectively, on an annualized basis for the second quarter of 2013, compared with 17.96 percent and 1.77 percent, respectively, for the second quarter of 2012. For the first six months of 2013, on an annualized basis, the Corporation’s ROE and ROA were 15.55 percent and 1.66 percent, respectively, compared with 17.35 percent and 1.69 percent, respectively, for the first six months of 2012. The decline in ROE and ROA for the second quarter and the first half of 2013, as compared to the same periods in 2012, resulted from capital and asset growth that outpaced modest earnings growth during the comparative periods.

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

Retail Banking: C&F Bank reported net income of $499,000 for the second quarter of 2013, compared to a net income of $618,000 for the second quarter of 2012. For the first six months of 2013, C&F Bank reported net income of $1.2 million, compared to a net income of $925,000 for the first six months of 2012. Factors contributing to the financial results for the three and six months end June 30, 2013 were the continued low interest rate environment on the cost of deposits and on the renewal rates on borrowings from the FHLB, a shift in deposit mix to lower rate non-term deposit accounts, the effects of improved credit quality on the loan loss provision and expenses associated with loan work-outs, lower expenses related to the holding costs of foreclosed properties and increased activity-based interchange and overdraft fee income. Offsetting these positive factors were the negative effects of the following: (1) a decrease in average loans to nonaffiliates resulting from weak loan demand in the current economic environment and intense competition for loans in our markets, (2) higher personnel costs associated with increased staff levels throughout the branch network and the addition of new personnel dedicated to growing C&F Bank's commercial and small business loan portfolios, (3) higher occupancy expenses associated with depreciation and maintenance of technology related to expanding the banking services offered to customers and improving operations efficiency and security, (4) higher expenses associated with the Bank promoting its brand and enhancing its lending platforms, and (5) a loss on the sale of a facility previously used by the Bank for its deposit operations in West Point, Virginia.

The Bank’s nonperforming assets were $10.7 million at June 30, 2013, compared to $17.7 million at December 31, 2012. Nonperforming assets at June 30, 2013 included $6.8 million in nonaccrual loans and $3.9 million in foreclosed properties, compared to $11.5 million in nonaccrual loans and $6.2 million in foreclosed properties at December 31, 2012. The decrease in nonaccrual loans was primarily the result of the sale of notes totaling $10.9 million relating to one commercial relationship, $5.2 million of which was on nonaccrual status at December 31, 2012. This note sale resulted in a $2.1 million charge-off, which had previously been provided for in the allowance for loan losses. As a result of this charge-off, the Bank's allowance for loan losses as a percentage of average loans declined to 3.01 percent at June 30, 2013 from 3.38 percent at December 31, 2012. Management believes it has provided adequate loan loss reserves for the Retail Banking segment’s nonaccrual loans.

Mortgage Banking: C&F Mortgage Corporation (or C&F Mortgage) reported net income of $986,000 for the second quarter of 2013, compared to $419,000 for the second quarter of 2012. For the first six months of 2013, C&F Mortgage reported net income of $1.5 million, compared to $837,000 for the first six months of 2012. During the second quarter of 2013, C&F Mortgage began selling a portion of loans originated for sale on a mandatory delivery basis, while continuing to sell the majority of its loans on a best efforts delivery basis. In addition, as permitted by U.S. GAAP, C&F Mortgage elected to use fair value accounting for loans held for sale and IRLCs, as well as for forward sales commitments that are used to hedge the effect of changes in interest rates on loans that are to be sold in the secondary market. Under fair value accounting, gains on loans sold in the secondary market are recognized as loans progress through the origination pipeline, as opposed to recognizing gains when the loans are sold, as was done in prior periods. The increase in pre-tax income attributable to the implementation of fair value accounting approximated $1.1 million for both the second quarter and first half of 2013. Net income at C&F Mortgage also included the favorable effects of higher loan production and lower provisions for indemnification losses. Loan origination volume increased to $212.0 million and $390.2 million in the second quarter and first half of 2013, respectively, compared to $206.7 million and $379.0 million in the second quarter and first half of 2012. During the second quarter of 2013, the amounts of loan originations for refinancings and new and resale home purchases were $72.1 million and $139.9 million, respectively, compared to $55.8 million and $150.9 million, respectively, during the second quarter of 2012. During the first half of 2013, the amounts of loan originations for refinancings and new and resale home purchases were $154.1 million and $236.1 million respectively, compared to $135.5 million and $244.5 million, respectively, during the first half of 2012.

Net income at C&F Mortgage also included the negative effects of (1) lower net interest income resulting from the continued low interest rate environment, (2) higher income-based compensation expenses and (3) higher non-production based personnel costs associated with expansion into Virginia Beach, Virginia and with regulatory compliance. If recent volatility in interest rates continues, including volatility of yields on U.S. Treasury bonds, C&F Mortgage may experience lower loan demand, particularly for refinancings, which could negatively affect earnings of the mortgage banking segment for the remainder of 2013, and possibly beyond.

Consumer Finance: C&F Finance Company (or C&F Finance) reported net income of $3.3 million for the second quarter of 2012, consistent with the second quarter of 2012. For the first six months of 2013, C&F Finance reported net income of $6.4 million, compared to net income of $6.5 million for the first six months of 2012. Average loans outstanding increased 9.60 percent and 11.17 percent, respectively, during the three and six months ended June 30, 2013. Additionally, the consumer finance segment continued to benefit from the low funding costs related to its variable-rate borrowings. Offsetting these items were (1) a decline in average loan yields in response to loan pricing strategies used by competitors to grow market share in automobile financing, (2) an increase in the provision for loan losses resulting from an increase in loan charge-offs and (3) an increase in personnel expenses incurred to support loan growth and segment expansion into new markets.

The allowance for loan losses as a percentage of consumer finance loans was 7.97 percent as of June 30, 2013, compared to 7.96 percent as of December 31, 2012. Management believes that the current allowance for loan losses is adequate to absorb probable losses in the Consumer Finance segment’s loan portfolio.

Other and Eliminations: The net loss for the three months ended June 30, 2013 for this combined segment was $646,000, compared to a net loss of $136,000 for the three months ended June 30, 2012. The net loss for the first half of 2013 for this combined segment was $932,000, compared to a net loss of $345,000 for the first half of 2012. This combined segment includes the Corporation's holding company, which recognized transaction costs of $581,000 and $782,000 during the second quarter and first half of 2013, respectively, associated with the Corporation's pending acquisition of CVB.

Capital Management. Total shareholders' equity was $105.8 million at June 30, 2013, compared to $102.2 million at December 31, 2012. Capital growth resulted from earnings for the first half of 2013, offset in part by dividends declared and a decline in unrealized holding gains on securities available for sale, which are a component of accumulated other comprehensive income. The Corporation declared cash dividends of 29 cents and 58 cents per common share during the second quarter and first half of 2013, respectively, which was a 22.7 percent and a 23.2 percent payout ratio of net income available to common shareholders for the second quarter and first half of 2013, respectively.

RESULTS OF OPERATIONS

The following table presents the average balance sheets, the amounts of interest earned on earning assets, with related yields, and interest expense on interest-bearing liabilities, with related rates, for the three months and six months ended June 30, 2013 and 2012. Loans include loans held for sale. Loans placed on nonaccrual status are included in the balances and are included in the computation of yields, but had no material effect. Interest on tax-exempt loans and securities is presented on a taxable-equivalent basis (which converts the income on loans and investments for which no income taxes are paid to the equivalent yield as if income taxes were paid using the federal corporate income tax rate of 34 percent).

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

(Dollars in thousands)	**Three Months Ended June 30, 2013 Average Balance**	**Income/ Expense**	**Yield/ Rate**	**2012 Average Balance**	**Income/ Expense**	**Yield/ Rate**
Assets						
Securities:						
Taxable	**$30,520**	**$137**	**1.80** %	$19,856	$82	1.65 %
Tax-exempt	**115,034**	**1,722**	**5.99**	118,709	1,797	6.06
Total securities	**145,554**	**1,859**	**5.11**	138,565	1,879	5.42
Loans, net	**720,237**	**17,929**	**9.98**	720,881	17,837	9.92
Interest-bearing deposits in other banks and Federal funds sold	**62,655**	**37**	**0.24**	10,558	5	0.19
Total earning assets	**928,446**	**19,825**	**8.56**	870,004	19,721	9.07
Allowance for loan losses	**(34,238)**			(35,180)		
Total non-earning assets	**95,019**			91,591		
Total assets	**$989,227**			$926,415		
Liabilities and Shareholders' Equity						
Time and savings deposits:						
Interest-bearing demand deposits	**$126,428**	**$95**	**0.30** %	$109,039	$97	0.36 %
Money market deposit accounts	**118,729**	**80**	**0.27**	92,975	90	0.39
Savings accounts	**50,059**	**11**	**0.09**	45,316	12	0.11
Certificates of deposit, $100 or more	**123,932**	**354**	**1.15**	138,831	546	1.58
Other certificates of deposit	**158,748**	**468**	**1.18**	164,072	637	1.56
Total time and savings deposits	**577,896**	**1,008**	**0.70**	550,233	1,382	1.00
Borrowings	**165,985**	**1,074**	**2.56**	159,961	1,215	3.04
Total interest-bearing liabilities	**743,881**	**2,082**	**1.11**	710,194	2,597	1.46
Noninterest-bearing demand deposits	**113,162**			103,450		
Other liabilities	**25,379**			20,275		
Total liabilities	**882,422**			833,919		
Shareholders' equity	**106,805**			92,496		
Total liabilities and shareholders' equity	**$989,227**			$926,415		
Net interest income		**$17,743**			$17,124	
Interest rate spread			**7.45** %			7.61 %
Interest expense to average earning assets (annualized)			**0.89** %			1.19 %
Net interest margin (annualized)			**7.67** %			7.87 %

	Six Months Ended June 30,					
	2013			2012		
(Dollars in thousands)	**Average Balance**	**Income/ Expense**	**Yield/ Rate**	Average Balance	Income/ Expense	Yield/ Rate
Assets						
Securities:						
Taxable	**$31,526**	**$277**	**1.76 %**	$20,610	$168	1.63 %
Tax-exempt	**115,206**	**3,452**	**5.99**	118,652	3,595	6.06
Total securities	**146,732**	**3,729**	**5.08**	139,262	3,763	5.40
Loans, net	**724,816**	**35,758**	**9.95**	716,166	35,327	9.94
Interest-bearing deposits in other banks and Federal funds sold	**51,903**	**60**	**0.23**	12,971	13	0.20
Total earning assets	**923,451**	**39,547**	**8.63**	868,399	39,103	9.01
Allowance for loan losses	**(35,013)**			(34,648)		
Total non-earning assets	**95,316**			92,318		
Total assets	**$983,754**			$926,069		
Liabilities and Shareholders' Equity						
Time and savings deposits:						
Interest-bearing demand deposits	**$129,800**	**$221**	**0.34 %**	$110,953	$239	0.43 %
Money market deposit accounts	**115,701**	**163**	**0.28**	89,745	190	0.43
Savings accounts	**49,316**	**21**	**0.09**	44,687	22	0.10
Certificates of deposit, $100 or more	**125,181**	**729**	**1.17**	139,025	1,187	1.72
Other certificates of deposit	**159,114**	**953**	**1.21**	166,293	1,361	1.65
Total time and savings deposits	**579,112**	**2,087**	**0.73**	550,703	2,999	1.09
Borrowings	**164,990**	**2,143**	**2.59**	159,489	2,437	3.06
Total interest-bearing liabilities	**744,102**	**4,230**	**1.14**	710,192	5,436	1.53
Noninterest-bearing demand deposits	**109,023**			98,922		
Other liabilities	**25,397**			21,450		
Total liabilities	**878,522**			830,564		
Shareholders' equity	**105,232**			95,505		
Total liabilities and shareholders' equity	**$983,754**			$926,069		
Net interest income		**$35,317**			$33,667	
Interest rate spread			**7.49 %**			7.48 %
Interest expense to average earning assets (annualized)			**0.92 %**			1.25 %
Net interest margin (annualized)			**7.71 %**			7.75 %

Interest income and expense are affected by fluctuations in interest rates, by changes in the volume of earning assets and interest-bearing liabilities, and by the interaction of rate and volume factors. The following table presents the direct causes of the period-to-period changes in the components of net interest income on a taxable-equivalent basis. We calculated the rate and volume variances using a formula prescribed by the SEC. Rate/volume variances, the third element in the calculation, are not shown separately in the table, but are allocated to the rate and volume variances in proportion to the relationship of the absolute dollar amounts of the change in each. Loans include both nonaccrual loans and loans held for sale.

TABLE 2: Rate-Volume Recap

	Three Months Ended June 30, 2013 from 2012 Increase (Decrease)		Total
(Dollars in thousands)	Due to Rate	Volume	Increase (Decrease)
Interest income:			
Loans	**$191**	**$ (99)**	**$ 92**
Securities:			
Taxable	**8**	**47**	**55**
Tax-exempt	**(20)**	**(55)**	**(75)**
Interest-bearing deposits in other banks and Federal funds sold	**2**	**30**	**32**
Total interest income	**181**	**(77)**	**104**
Interest expense:			
Time and savings deposits:			
Interest-bearing deposits	**(64)**	**62**	**(2)**
Money market deposit accounts	**(111)**	**101**	**(10)**
Savings accounts	**(7)**	**6**	**(1)**
Certificates of deposit, $100 or more	**(138)**	**(54)**	**(192)**
Other certificates of deposit	**(149)**	**(20)**	**(169)**
Total time and savings deposits	**(469)**	**95**	**(374)**
Borrowings (including Trust preferred capital notes)	**(410)**	**269**	**(141)**
Total interest expense	**(879)**	**364**	**(515)**
Change in net interest income	**$1,060**	**$ (441)**	**$ 619**

	Six Months Ended June 30, 2013 from 2012 Increase (Decrease) Due to		Total
(Dollars in thousands)	Rate	Volume	Increase (Decrease)
Interest income:			
Loans	**$33**	**$ 398**	**$ 431**
Securities:			
Taxable	**14**	**95**	**109**
Tax-exempt	**(40)**	**(103)**	**(143)**
Interest-bearing deposits in other banks and Federal funds sold	**2**	**45**	**47**
Total interest income	**9**	**435**	**444**
Interest expense:			
Time and savings deposits:			
Interest-bearing deposits	**(98)**	**80**	**(18)**
Money market deposit accounts	**(135)**	**108**	**(27)**
Savings accounts	**(6)**	**5**	**(1)**
Certificates of deposit, $100 or more	**(349)**	**(109)**	**(458)**
Other certificates of deposit	**(351)**	**(57)**	**(408)**
Total time and savings deposits	**(939)**	**27**	**(912)**
Borrowings (including Trust preferred capital notes)	**(515)**	**221**	**(294)**
Total interest expense	**(1,454)**	**248**	**(1,206)**
Change in net interest income	**$1,463**	**$ 187**	**$ 1,650**

Net interest income, on a taxable-equivalent basis, for the three months ended June 30, 2013 was $17.7 million, compared to $17.1 million for the three months ended June 30, 2012. Net interest income, on a taxable-equivalent basis, for the first half of 2013 was $35.3 million, compared to $33.7 million for the first half of 2012. The increase in net interest income for the three and six months ended June 30, 2013, compared to the same periods in 2012, was a result of an increase in average earning assets for both periods, offset somewhat by a decrease in the net interest margin for both periods. Net interest margin decreased 20 basis points to 7.67 percent for the second quarter of 2013 and decreased four basis points to 7.71 percent for the first half of 2013 relative to the same periods in 2012. The decreases in net interest margin during 2013 can be attributed to a decrease in the yield on interest-earning assets offset in part by decreases in the cost of interest-bearing liabilities and an increase in demand deposits that pay no interest. The decrease in the yield on interest-earning assets was primarily attributable to a large increase in interest-bearing deposits in other banks and federal funds sold, which segment of earning assets provides the lowest yield of all segments of earning assets, and a decrease in the yield on the investment portfolio. The decrease in the cost of interest-bearing liabilities is a result of the sustained low interest rate environment and the repricing of higher-rate certificates of deposit and borrowings as they mature to lower rates. In addition, the mix in interest bearing deposits has shifted to non-term deposits, including demand deposits and low-cost interest-bearing demand deposits, money market deposits and savings accounts.

Average loans, which includes both loans held for investment and loans held for sale, remained relatively level at $720.2 million for the second quarter of 2013 from $720.9 million for the first quarter of 2013. However, average loans increased $8.6 million to $724.8 million for the first half of 2013 from $716.2 million for the first half of 2012. In total, average loans to nonaffiliates held for investment increased $9.8 million during the second quarter of 2013 and $17.3 million during the first half of 2013, compared to the same periods of 2012. Increases in average loans to nonaffiliates during 2013 were primarily related to increases in the Consumer Finance segment's average loan portfolio, which increased $24.7 million during the second quarter of 2013 and $28.3 million during the second half of 2013. The increase in average loans at the Consumer Finance segment was offset in part by $15.2 million and $11.1 million decreases in the Retail Banking segment's portfolio of average loans held for investment, where loan production has been negatively affected by weak demand for new loans in the current economic environment and intense competition for loans in our markets. The Mortgage Banking segment's average portfolio of loans held for sale decreased $10.4 million during the second quarter and $8.6 million during the second half of 2013, compared to the same periods of 2012. While the demand for mortgage borrowing and refinancing activity during the second quarter and first half of 2013 resulted in increases in loan originations of $5.4 million and $10.2 million, respectively, when compared to the same periods of 2012, the mortgage banking segment's average balance of loans held for sale fluctuates depending on the period of time between mortgage loan origination and sale to a third-party investor.

The overall yield on average loans increased 6 basis points to 9.98 percent for the second quarter of 2013 and one basis point to 9.95 percent for the first half of 2013, when compared to the same periods of 2012. These increases were principally the result of the lower average balance of the Mortgage Banking segment's lower-yielding loans held for sale, the decline in average balance of the Retail Banking segment's loans to nonaffiliates, and the higher average balance of the Consumer Finance segment's higher-yielding loans as a percentage of total loans.

Average securities available for sale increased $7.0 million for the second quarter of 2013 and $7.5 million for the second half of 2013, compared to the same periods of 2012. The average balance of shorter-term securities of U.S. government agencies and corporations increased $10.7 million and $10.9 million, respectively, while the average balance of longer-term tax exempt municipal securities declined $3.7 million and $3.4 million, respectively, during the second quarter and first half of 2013. Shifts in the mix of investments were attributable to (1) collateral requirements to support municipal deposits and (2) reinvesting the proceeds from calls and maturities of longer-term investments to shorter-term investments to limit the Corporation's exposure to potential future rising interest rate environments. The lower yield on the available-for-sale securities portfolio during the second quarter and first half of 2013 resulted from the calls and maturities of higher-yielding securities and purchases of lower-yielding shorter-term securities, as described above.

Average interest-bearing deposits in other banks and Federal funds sold increased $52.1 million and $38.9 million, respectively, during the second quarter and first half of 2013, when compared to the same periods of 2012, as a result of deposit growth and lower loan funding needs of the Retail Banking and Mortgage Banking segments. The average yield on these overnight funds increased five basis points and three basis points during the second quarter and first half of 2013, respectively.

Average interest-bearing time and savings deposits increased $27.7 million in the second quarter of 2013 and $28.4 million in the first half of 2013, compared to the same periods in 2012. These increases were a result of higher average interest-bearing demand, money market and savings deposits. The average cost of interest-bearing deposits declined 30 basis points during the second quarter of 2013 and 36 basis points during the first half of 2013, compared to the same periods of 2012. These decreases resulted from (1) the repricing of time deposits that matured throughout 2012 and into 2013 to lower interest rates, (2) a decline in interest rates paid on NOW, money market deposit and savings accounts in the sustained low interest rate environment and (3) a shift in deposit composition to non-term savings and money market deposits, which pay lower interest rates.

Average borrowings increased $6.0 million and $5.5 million during the second quarter and first half of 2013, compared to the same periods of 2012. These increases occurred in retail overnight repurchase agreements with commercial depositors. The average cost of borrowings declined 48 basis points and 47 basis points during the second quarter and first half of 2013, compared to the same period of 2012, because of the maturity of $10.0 million of FHLB advances during the third quarter of 2012, which were replaced by advances carrying lower interest rates. In addition, $5.0 million of trust preferred capital notes issued in 2007 converted to a lower variable rate from a higher fixed rate near the end of 2012.

It will be challenging to maintain the Retail Banking segment's net interest margin at its current level if funds obtained from loan repayments and from deposit growth cannot be fully used to originate new loans and instead are reinvested in lower-yielding earning assets, and if the reduction in earning asset yields exceeds interest rate declines in interest-bearing liabilities, which are approaching their interest rate floors. If the current volatility in the ten-year treasury yield continues, the Mortgage Banking segment may experience lower loan demand, particularly for refinancings, which could reduce interest income on loans originated for sale, further contributing to a deterioration in net interest margin. The net interest margin at the Consumer Finance segment will be most affected by increasing competition and loan pricing strategies that competitors may use to grow market share in automobile financing. This may result result in lower yields as the Consumer Finance segment responds to competitive pricing pressures and fewer purchases of automobile retail installment sales contracts.

Noninterest Income

TABLE 3: Noninterest Income

(Dollars in thousands)	**Three Months Ended June 30, 2013**				
	Retail Banking	**Mortgage Banking**	**Consumer Finance**	**Other and Eliminations**	**Total**
Gains on sales of loans	**$—**	**$ 3,577**	**$ —**	**$ —**	**$3,577**
Service charges on deposit accounts	**996**	**—**	**—**	**—**	**996**
Other service charges and fees	**677**	**758**	**2**	**35**	**1,472**
Gains on calls of available for sale securities	**4**	**—**	**—**	**—**	**4**
Other income	**12**	**328**	**274**	**300**	**914**
Total noninterest income	**$1,689**	**$ 4,663**	**$ 276**	**$ 335**	**$6,963**

(Dollars in thousands)	**Three Months Ended June 30, 2012**				
	Retail Banking	**Mortgage Banking**	**Consumer Finance**	**Other and Eliminations**	**Total**
Gains on sales of loans	$—	$ 1,631	$ —	$ —	$1,631
Service charges on deposit accounts	825	—	—	—	825
Other service charges and fees	608	941	2	57	1,608
Gains on calls of available for sale securities	8	—	—	—	8
Other income	23	38	232	277	570
Total noninterest income	$1,464	$ 2,610	$ 234	$ 334	$4,642

(Dollars in thousands)	**Six Months Ended June 30, 2013**				
	Retail Banking	**Mortgage Banking**	**Consumer Finance**	**Other and Eliminations**	**Total**
Gains on sales of loans	**$—**	**$ 5,278**	**$ —**	**$ —**	**$5,278**
Service charges on deposit accounts	**1,920**	**—**	**—**	**—**	**1,920**
Other service charges and fees	**1,321**	**1,573**	**4**	**78**	**2,976**
Gains on calls of available for sale securities	**6**	**—**	**—**	**—**	**6**
Other income	**153**	**591**	**570**	**567**	**1,881**
Total noninterest income	**$3,400**	**$ 7,442**	**$ 574**	**$ 645**	**$12,061**

(Dollars in thousands)	**Six Months Ended June 30, 2012**				
	Retail Banking	**Mortgage Banking**	**Consumer Finance**	**Other and Eliminations**	**Total**
Gains on sales of loans	$—	$ 2,962	$ —	$ —	$2,962
Service charges on deposit accounts	1,626	—	—	—	1,626
Other service charges and fees	1,178	1,701	6	91	2,976
Gains on calls of available for sale securities	8	—	—	—	8
Other income	218	394	488	581	1,681
Total noninterest income	$3,030	$ 5,057	$ 494	$ 672	$9,253

Total noninterest income increased $2.3 million, or 50.0 percent, in the second quarter of 2013 and increased $2.8 million, or 30.3 percent, in the first half of 2013, compared to the same periods in 2012. These increases resulted predominantly from higher gains on sales of loans, which resulted from increased loan production and the election to use fair value accounting for the Mortgage Banking segment's portfolio of loans held for sale and IRLCs. Gains on sales of loans for prior periods have been restated to conform to current year presentation. In addition, the Retail Banking segment recognized higher activity-based debit card interchange and overdraft fee income during the second quarter and first half of 2013, compared to the same periods in 2012.

Noninterest Expense

TABLE 4: Noninterest Expenses

(Dollars in thousands)	**Three Months Ended June 30, 2013**				
	Retail Banking	**Mortgage Banking**	**Consumer Finance**	**Other and Eliminations**	**Total**
Salaries and employee benefits	**$4,067**	**$ 2,009**	**$ 1,944**	**$ 209**	**$8,229**
Occupancy expenses	**1,091**	**465**	**208**	**6**	**1,770**
Other expenses:					
OREO expenses	**332**	**—**	**—**	**—**	**332**
Provision for indemnification losses	**—**	**150**	**—**	**—**	**150**
Other expenses	**1,805**	**700**	**852**	**710**	**4,067**
Total other expenses	**2,137**	**850**	**852**	**710**	**4,549**
Total noninterest expenses	**$7,295**	**$ 3,324**	**$ 3,004**	**$ 925**	**$14,548**

(Dollars in thousands)	**Three Months Ended June 30, 2012**				
	Retail Banking	**Mortgage Banking**	**Consumer Finance**	**Other and Eliminations**	**Total**
Salaries and employee benefits	$3,742	$ 723	$ 1,846	$ 198	$6,509
Occupancy expenses	974	485	213	5	1,677
Other expenses:					
OREO expenses	200	—	—	—	200
Provision for indemnification losses	—	330	—	—	330
Other expenses	1,688	798	838	100	3,424
Total other expenses	1,888	1,128	838	100	3,954
Total noninterest expenses	$6,604	$ 2,336	$ 2,897	$ 303	$12,140

(Dollars in thousands)	**Six Months Ended June 30, 2013**				
	Retail Banking	**Mortgage Banking**	**Consumer Finance**	**Other and Eliminations**	**Total**
Salaries and employee benefits	**$8,209**	**$ 2,754**	**$ 3,934**	**$ 401**	**$15,298**
Occupancy expenses	**2,177**	**944**	**410**	**7**	**3,538**
Other expenses:					
OREO expenses	**384**	**—**	**—**	**—**	**384**
Provision for indemnification losses	**—**	**375**	**—**	**—**	**375**
Other expenses	**3,692**	**1,425**	**1,764**	**1,101**	**7,982**
Total other expenses	**4,076**	**1,800**	**1,764**	**1,101**	**8,741**
Total noninterest expenses	**$14,462**	**$ 5,498**	**$ 6,108**	**$ 1,509**	**$27,577**

(Dollars in thousands)	**Six Months Ended June 30, 2012**				
	Retail Banking	**Mortgage Banking**	**Consumer Finance**	**Other and Eliminations**	**Total**
Salaries and employee benefits	$7,748	$ 1,534	$ 3,722	$ 475	$13,479
Occupancy expenses	2,006	961	418	13	3,398
Other expenses:					
OREO expenses	442	—	—	—	442
Provision for indemnification losses	—	455	—	—	455
Other expenses	3,324	1,529	1,556	242	6,651
Total other expenses	3,766	1,984	1,556	242	7,548
Total noninterest expenses	$13,520	$ 4,479	$ 5,696	$ 730	$24,425

Total noninterest expenses increased $2.4 million, or 19.8 percent, in the second quarter of 2013 and increased $3.2 million or 12.9 percent, in the first half of 2013, compared to the same periods in 2012. These increases resulted primarily from higher personnel costs at (1) the Retail Banking segment due to increased staffing in the branch network to support customer service initiatives and the addition of new personnel dedicated to growing the Bank's commercial and small business loan portfolio, (2) the Mortgage Banking segment due to higher production-based and income-based expenses, as well as higher non-production based compensation associated with the expansion into Virginia Beach, Virginia and with regulatory compliance and (3) the Consumer Finance segment due to an increase in the number of personnel to support expansion into new markets and loan growth. In addition, during the second quarter of 2013, the Retail Banking segment recognized a loss on the sale of a facility previously used for the Bank's deposit operations in West Point, Virginia; the Consumer Finance segment recognized higher volume-related expenses associated with loan underwriting and collection activities, and the Corporation's holding company recognized $581,000 in transaction costs associated with the Corporation's pending acquisition of CVB. These increases were partially offset by a lower provision for indemnification losses in connection with loans sold to investors at the Mortgage Banking segment. Salaries and employee benefits for prior periods at the Mortgage Banking segment have been restated to conform to current year presentation.

Income Taxes

Income tax expense for the second quarter of 2013 totaled $2.3 million, resulting in an effective tax rate of 35.2 percent, compared to $2.0 million and 31.9 percent for the second quarter of 2012. Income tax expense for the first half of 2013 totaled $4.1 million, resulting in an effective tax rate of 33.5 percent, compared to $3.7 million and 31.7 percent for the first half of 2012. The increases in the effective tax rates during the second quarter and first half of 2013 were a result of higher combined pre-tax earnings at the non-bank business segments, which are not exempt from state income taxes and do not generate tax-exempt income. In addition, the Corporation's holding company recognized $430,000 of nondeductible transaction expenses associated with the pending acquisition of CVB during the first six months of 2013, compared to no such expenses in 2012.

ASSET QUALITY

Allowance for Loan Losses

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

TABLE 5: Allowance for Loan Losses

	Three Months Ended June 30,	
(Dollars in thousands)	**2013**	**2012**
Allowance, beginning of period	**$33,921**	$34,757
Provision for loan losses:		
Retail Banking segment	**600**	750
Mortgage Banking segment	**30**	30
Consumer Finance segment	**2,490**	2,080
Total provision for loan losses	**3,120**	2,860
Loans charged off:		
Real estate—residential mortgage	**2**	516
Real estate—construction [1]	**—**	—
Commercial, financial and agricultural [2]	**136**	402
Equity lines	**—**	—
Consumer	**44**	81
Consumer finance	**2,968**	1,902
Total loans charged off	**3,150**	2,901
Recoveries of loans previously charged off:		
Real estate—residential mortgage	**7**	13
Real estate—construction [1]	**—**	—
Commercial, financial and agricultural [2]	**52**	1
Equity lines	**—**	—
Consumer	**32**	50
Consumer finance	**787**	677
Total recoveries	**878**	741
Net loans charged off	**2,272**	2,160
Allowance, end of period	**$34,769**	$35,457

Ratio of annualized net charge-offs to average total loans outstanding during period for Retail Banking and Mortgage Banking	**0.09 %**	0.92 %
Ratio of annualized net charge-offs to average total loans outstanding during period for Consumer Finance	**3.09 %**	1.90 %

(Dollars in thousands)	**Six Months Ended June 30, 2013**	**2012**
Allowance, beginning of period	**$35,907**	$33,677
Provision for loan losses:		
Retail Banking segment	**1,000**	1,500
Mortgage Banking segment	**60**	105
Consumer Finance segment	**5,240**	3,980
Total provision for loan losses	**6,300**	5,585
Loans charged off:		
Real estate—residential mortgage	**475**	638
Real estate—construction [1]	**—**	—
Commercial, financial and agricultural [2]	**2,270**	402
Equity lines	**37**	121
Consumer	**228**	171
Consumer finance	**6,361**	4,102
Total loans charged off	**9,371**	5,434
Recoveries of loans previously charged off:		
Real estate—residential mortgage	**86**	23
Real estate—construction [1]	**—**	—
Commercial, financial and agricultural [2]	**60**	36
Equity lines	**27**	—
Consumer	**79**	99
Consumer finance	**1,681**	1,471
Total recoveries	**1,933**	1,629
Net loans charged off	**7,438**	3,805
Allowance, end of period	**$34,769**	$35,457
Ratio of annualized net charge-offs to average total loans outstanding during period for Retail Banking and Mortgage Banking	**1.40 %**	0.58 %
Ratio of annualized net charge-offs to average total loans outstanding during period for Consumer Finance	**3.33 %**	2.08 %

[1] Includes the Corporation’s real estate construction lending and consumer real estate lot lending.

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

For the six months ended June 30, 2013, the annualized net charge-off ratio for the combined Retail Banking and Mortgage Banking segments includes a $2.1 million charge-off for a single commercial lending relationship. As of June 30, 2013, the Corporation does not anticipate incurring similar charge-offs of large lending relationships during the remainder of 2013.

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Table 6 discloses the allocation of the allowance for loan losses at June 30, 2013 and December 31, 2012.

TABLE 6: Allocation of Allowance for Loan Losses

(Dollars in thousands)	**June 30, 2013**	**December 31, 2012**
Allocation of allowance for loan losses:		
Real estate—residential mortgage	**$2,491**	$ 2,358
Real estate—construction [1]	**474**	424
Commercial, financial and agricultural [2]	**7,942**	9,824
Equity lines	**886**	885
Consumer	**283**	283
Consumer finance	**22,693**	22,133
Balance	**$34,769**	$ 35,907

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

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

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

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

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

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

- Doubtful loans have all the weaknesses inherent in a loan that is classified substandard but with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable. The possibility of loss is extremely high.

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

TABLE 7: Credit Quality Indicators

Loans by credit quality indicators as of June 30, 2013 were as follows:

(Dollars in thousands)	Pass	Special Mention	Substandard	Substandard Nonaccrual	Total[1]
Real estate—residential mortgage	**$146,091**	**$ 1,441**	**$ 1,703**	**$ 2,136**	**$151,371**
Real estate—construction[2]	**2,401**	**—**	**2,929**	**—**	**5,330**
Commercial, financial and agricultural[3]	**166,304**	**4,420**	**18,424**	**4,266**	**193,414**
Equity lines	**31,071**	**1,116**	**706**	**211**	**33,104**
Consumer	**4,692**	**3**	**368**	**188**	**5,251**
	$350,559	**$ 6,980**	**$ 24,130**	**$ 6,801**	**$388,470**

(Dollars in thousands)	Performing	Non-Performing	Total
Consumer finance	**$ 284,176**	**$ 680**	**$284,856**

[1] At June 30, 2013, the Corporation did not have any loans classified as Doubtful or Loss.
[2] Includes the Corporation's real estate construction lending and consumer real estate lot lending.
[3] Includes the Corporation's commercial real estate lending, land acquisition and development lending, builder line lending and commercial business lending.

Loans by credit quality indicators as of December 31, 2012 were as follows:

(Dollars in thousands)	Pass	Special Mention	Substandard	Substandard Nonaccrual	Total[1]
Real estate – residential mortgage	$143,947	$ 1,374	$ 2,131	$ 1,805	$149,257
Real estate – construction[2]	2,133	—	2,929	—	5,062
Commercial, financial and agricultural[3]	167,693	6,678	21,247	9,434	205,052
Equity lines	31,199	1,327	767	31	33,324

Consumer	4,746	3	369	191	5,309
	$349,718	$ 9,382	$ 27,443	$ 11,461	$398,004

(Dollars in thousands)	**Performing**	**Non-Performing**	**Total**
Consumer finance	$ 277,531	$ 655	$278,186

[1] At December 31, 2012, the Corporation did not have any loans classified as Doubtful or Loss.
[2] Includes the Corporation's real estate construction lending and consumer real estate lot lending.
[3] Includes the Corporation's commercial real estate lending, land acquisition and development lending, builder line lending and commercial business lending.

The combined Retail Banking and Mortgage Banking segments' allowance for loan losses decreased $1.7 million since December 31, 2012, and the provision for loan losses at these combined segments decreased $150,000 and $545,000 during the second quarter and first half of 2013, compared to the same periods in 2012. The allowance for loan losses to total loans for these combined segments declined to 3.11 percent at June 30, 2013, compared to 3.46 percent at December 31, 2012. These declines resulted from improved credit quality in part due to the resolution of certain notes that were on nonaccrual status, as discussed below. Substandard nonaccrual loans decreased to $6.8 million at June 30, 2013 from $11.5 million at December 31, 2012. The decline in these balances and the allowance ratio occurred primarily as a result of the sale of notes totaling $10.9 million related to one commercial relationship, $5.2 million of which was a troubled debt restructuring on nonaccrual status at December 31, 2012. This note sale resulted in a $2.1 million charge-off. Loss reserves that had previously been recorded for this relationship were adequate to cover the associated charge-off. Special mention and substandard loans also decreased as a result of improved loan performance. We believe that the current level of the allowance for loan losses at the combined Retail Banking and Mortgage Banking segments is adequate to absorb any losses on existing loans that may become uncollectible. If current economic conditions continue or worsen, a higher level of nonperforming loans may be experienced in future periods, which may then require a higher provision for loan losses.

The Consumer Finance segment's allowance for loan losses increased to $22.7 million at June 30, 2013 from $22.1 million at December 31, 2012, and its provision for loan losses increased $410,000 and $1.3 million during the second quarter and first half of 2013, compared to the same periods in 2012. The allowance for loan losses as a percentage of loans at June 30, 2013 was 7.97 percent, compared with 7.96 percent at December 31, 2012. The increase in the provision for loan losses during the first half of 2013 was primarily attributable to higher net charge-offs, which resulted from current economic conditions and lower resale prices of repossessed automobiles. We believe that the current level of the allowance for loan losses at the Consumer Finance segment is adequate to absorb any losses on existing loans that may become uncollectible. However, if unemployment levels remain elevated or increase in the future, or if consumer demand for automobiles falls and results in declining values of automobiles securing outstanding loans, a higher provision for loan losses may become necessary.

Nonperforming Assets

Table 8 summarizes nonperforming assets at June 30, 2013 and December 31, 2012.

TABLE 8: Nonperforming Assets

Retail Banking and Mortgage Banking Segments

(Dollars in thousands)	**June 30, 2013**		**December 31, 2012**	
Nonaccrual loans* - Retail Banking	**$6,801**		$11,461	
Nonaccrual loans - Mortgage Banking	—		—	
OREO** - Retail Banking	**3,925**		6,236	
OREO** - Mortgage Banking	**—**		**—**	
Total nonperforming assets	**$10,726**		$17,697	
Accruing loans past due for 90 days or more	**$106**		$—	
Troubled debt restructurings	**$7,229**		$16,492	
Total loans	**$388,470**		$398,004	
Allowance for loan losses	**$12,076**		$13,774	
Nonperforming assets to total loans and OREO*	**2.73**	%	4.38	%
Allowance for loan losses to total loans	**3.11**		3.46	
Allowance for loan losses to nonaccrual loans	**177.56**		120.18	

* Nonaccrual loans include nonaccrual TDRs of $4.46 million at June 30, 2013 and $9.80 million at December 31, 2012.
** OREO is recorded at its estimated fair value less cost to sell.

Consumer Finance Segment

(Dollars in thousands)	**June 30, 2013**	**December 31, 2012**
Nonaccrual loans	**$680**	$655
Accruing loans past due for 90 days or more	**$—**	$—
Total loans	**$284,856**	$278,186
Allowance for loan losses	**$22,693**	$22,133
Nonaccrual consumer finance loans to total consumer finance loans	**0.24 %**	0.24 %
Allowance for loan losses to total consumer finance loans	**7.97**	7.96

Nonperforming assets of the combined Retail Banking and Mortgage Banking segments totaled $10.7 million at June 30, 2013, compared to $17.7 million at December 31, 2012. Nonperforming assets at June 30, 2013 included $6.8 million of nonaccrual loans at the Retail Banking segment, compared to $11.5 million at December 31, 2012, and $3.9 million of OREO compared to $6.2 million at December 31, 2012. The decrease in nonaccrual loans since December 31, 2012 was primarily attributable to the sale of notes related to one commercial relationship, $5.2 million of which was on nonaccrual status at December 31, 2012. This note sale resulted in a $2.1 million charge-off which reduced the combined Retail Banking and Mortgage Banking segments' ratio of the allowance for loan losses to total loans to 3.11 percent at June 30, 2013 from 3.46 percent at December 31, 2012. Despite the decline in this ratio, the ratio of the allowance for loan losses to nonaccrual loans increased to 177.56 percent at June 30, 2013 from 120.18 percent at December 31, 2012. We believe we have provided adequate loan loss reserves based on current appraisals or evaluations of the collateral. In some cases, appraisals have been adjusted to reflect current trends including sales prices, expenses, absorption periods and other current relevant factors. OREO properties at June 30, 2013 primarily consisted of residential and non-residential properties associated with commercial relationships. These properties have been written down to their estimated fair values less cost to sell. The decline in OREO properties since December 31, 2012 resulted from sales during the first half of 2013 as the Corporation continues to focus efforts on disposing of OREO property, as well as additional write-downs based on updated appraisals.

Nonaccrual loans at the Consumer Finance segment increased slightly to $680,000 at June 30, 2013 from $655,000 at December 31, 2012. As noted above, the allowance for loan losses at the Consumer Finance segment increased from $22.1 million at December 31, 2012 to $22.7 million at June 30, 2013, and the ratio of the allowance for loan losses to total consumer finance loans was 7.97 percent as of June 30, 2013, compared with 7.96 percent at December 31, 2012. Nonaccrual consumer finance loans remain relatively low compared to the allowance for loan losses and the total consumer finance loan portfolio because the Consumer Finance segment generally initiates repossession of loan collateral once a loan is 60 days or more past due but before the loan reaches 90 days or more past due and is evaluated for nonaccrual status.

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

TABLE 9: Impaired Loans

Impaired loans, which consisted solely of TDRs, and the related allowance at June 30, 2013, were as follows:

(Dollars in thousands)	Recorded Investment in Loans	Unpaid Principal Balance	Related Allowance	Average Balance-Impaired Loans	Interest Income Recognized
Real estate – residential mortgage	$ 1,753	$ 1,981	$ 369	$ 2,089	$ 49
Commercial, financial and agricultural:					
Commercial real estate lending	4,338	4,527	624	4,349	82
Builder line lending	14	17	4	15	—
Commercial business lending	801	805	203	807	4
Consumer	323	323	48	323	6
Total	$ 7,229	$ 7,653	$ 1,248	$ 7,583	$ 141

Impaired loans, which consisted solely of TDRs, and the related allowance at December 31, 2012, were as follows:

(Dollars in thousands)	**Recorded Investment in Loans**	**Unpaid Principal Balance**	**Related Allowance**	**Average Balance-Impaired Loans**	**Interest Income Recognized**
Real estate – residential mortgage	$ 2,230	$ 2,283	$ 433	$ 2,266	$ 124
Commercial, financial and agricultural:					
Commercial real estate lending	7,892	8,190	1,775	8,260	254
Land acquisition and development lending	5,234	5,234	1,432	5,443	236
Builder line lending	—	—	—	1,407	—
Commercial business lending	812	817	112	827	13
Consumer	324	324	49	324	16
Total	$ 16,492	$ 16,848	$ 3,801	$ 18,527	$ 643

Impaired loans at June 30, 2013 and December 31, 2012, which consisted solely of TDRs, were $7.2 million and $16.5 million, respectively. As previously described, the decline in impaired loans during the first half of 2013 resulted primarily from the sale of notes related to one commercial relationship, $9.1 million (which is net of a $ 1.7 million participation sold) of which was a TDR at December 31, 2012. The Corporation has no obligation to fund additional advances on its impaired loans. As the Retail Banking segment's loan portfolio remains under credit quality pressure, the Corporation may use loan modifications as a responsible approach to managing asset quality when working with borrowers who are experiencing financial difficulty, which may result in additional TDRs.

TDRs at June 30, 2013 and December 31, 2012 were as follows:

TABLE 10: Troubled Debt Restructurings

(Dollars in thousands)	**June 30, 2013**	**December 31, 2012**
Accruing TDRs	**$2,771**	$ 6,692
Nonaccrual TDRs[1]	**4,458**	9,800

Total TDRs[2]	**$7,229**	$ 16,492

[1] Included in nonaccrual loans in Table 8: Nonperforming Assets.
[2] Included in impaired loans in Table 9: Impaired Loans.

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

FINANCIAL CONDITION

At June 30, 2013, the Corporation had total assets of $992.7 million compared to $977.0 million at December 31, 2012. The increase was principally a result of an increase in interest-bearing deposits in other banks due to excess liquidity provided by deposit growth and reduced loan funding needs of the Retail Banking and Mortgage Banking segments. The decision to deploy excess liquidity in interest-bearing deposits in other banks was influenced by the lack of attractively-priced investment securities available for purchase during the first half of 2013 and continued weak loan demand at the Retail Banking segment in the current economic environment and intense competition for loans.

Loan Portfolio

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

TABLE 11: Summary of Loans Held for Investment

	June 30, 2013			**December 31, 2012**		
(Dollars in thousands)	**Amount**	**Percent**		**Amount**	**Percent**	
Real estate – residential mortgage	**$151,371**	**22**	**%**	$149,257	22	%
Real estate – construction[1]	**5,330**	**1**		5,062	1	
Commercial, financial and agricultural [2]	**193,414**	**29**		205,052	30	
Equity lines	**33,104**	**5**		33,324	5	
Consumer	**5,251**	**1**		5,309	1	
Consumer finance	**284,856**	**42**		278,186	41	
Total loans	**673,326**	**100**	**%**	676,190	100	%
Less allowance for loan losses	**(34,769)**			(35,907)		
Total loans, net	**$638,557**			$640,283		

[1] Includes the Corporation’s real estate construction lending and consumer real estate lot lending.

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

The decline in loans held for investment since December 31, 2012 was primarily attributable to weak loan demand at the Retail Banking segment. The decline was offset in part by growth in the Consumer Finance segment's loan portfolio.

Investment Securities

The investment portfolio plays a primary role in the management of the Corporation’s interest rate sensitivity. In addition, the portfolio serves as a source of liquidity and is used as needed to meet collateral requirements. The investment portfolio consists of securities available for sale, which may be sold in response to changes in market interest rates, changes in prepayment risk, changes in loan demand, general liquidity needs and other similar factors. These securities are carried at estimated fair value. At June 30, 2013 and December 31, 2012, all securities in the Corporation's investment portfolio were classified as available for sale.

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

TABLE 12: Securities Available for Sale

	June 30, 2013		**December 31, 2012**	
(Dollars in thousands)	**Amount**	**Percent**	**Amount**	**Percent**
U.S. government agencies and corporations	**$21,759**	**15 %**	$24,649	16 %
Mortgage-backed securities	**3,155**	**2**	2,189	2
Obligations of states and political subdivisions	**122,416**	**83**	125,875	82
Total debt securities	**147,330**	**100 %**	152,713	100 %
Preferred stock	**258**	*****	104	*
Total available for sale securities at fair value	**$147,588**	**100 %**	$152,817	100 %

*Less than one percent.

For more information about the Corporation's securities available for sale, including a description of securities in an unrealized loss position at June 30, 2013 and December 31, 2012, see Note 2 to the consolidated financial statements filed with this Report.

Deposits

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

Deposits totaled $693.8 million at June 30, 2013, compared to $686.2 million at December 31, 2012. The increase occurred primarily in noninterest-bearing demand deposits, which increased $11.8 million, or 11.1 percent, from December 31, 2012 to June 30, 2013. Savings and interest-bearing demand deposits increased $1.5 million since December 31, 2012, while time deposits declined $5.7 million since December 31, 2012. The Corporation had $1.9 million in brokered money market deposits outstanding at June 30, 2013, compared to $2.8 million at December 31, 2012. The source of these brokered deposits is uninvested cash balances held in third-party brokerage sweep accounts. The Corporation uses brokered deposits as a means of diversifying liquidity sources, as opposed to a long-term deposit gathering strategy.

Borrowings

Borrowings increased to $167.1 million at June 30, 2013 from $162.7 million at December 31, 2012 as a result of a $4.4 million increase in retail overnight repurchase agreements with commercial depositors, the level of which is a function of the deposit balances maintained by these depositors.

Off-Balance Sheet Arrangements

During the second quarter of 2013, the Corporation began selling a portion of loans originated for sale on a mandatory delivery basis, while continuing to sell the majority of its loans on a best efforts delivery basis. In order to mitigate the effect of changes in interest rates on loans that are to be sold in the secondary market, the Corporation entered into forward sales contracts on loans and MBS. Forward sales contracts are recorded at fair value with changes in fair value recorded in noninterest income. As of June 30, 2013, the notional value and fair value of the Corporation's forward sales contracts were $143.0 million and $303,000, respectively.

Contractual Obligations

As of June 30, 2013, there have been no material changes outside the ordinary course of business to the contractual obligations disclosed in “Management’s Discussion and Analysis” in the Corporation’s Annual Report on Form 10-K for the year ended December 31, 2012.

Liquidity

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

Liquid assets, which include cash and due from banks, interest-bearing deposits at other banks, federal funds sold and nonpledged securities available for sale, at June 30, 2013 totaled $94.4 million, compared to $63.3 million at December 31, 2012. The increase in liquid assets since December 31, 2012 resulted primarily from reduced funding needs of the mortgage banking segment, coupled with deposit growth. The Corporation’s funding sources for borrowings, including the capacity, amount outstanding and amount available at June 30, 2013 are presented in Table 13.

TABLE 13: Funding Sources

	June 30, 2013		
(Dollars in thousands)	**Capacity**	**Outstanding**	**Available**
Federal funds purchased	$59,000	$ —	$59,000
Wholesale repurchase agreements	5,000	5,000	—
Borrowings from FHLB	118,559	52,500	66,059
Borrowings from Federal Reserve Bank	43,703	—	43,703
Revolving line of credit	120,000	75,487	44,513
Total	$346,262	$ 132,987	$213,275

We have no reason to believe these arrangements will not be renewed at maturity. Additional loans and securities are also available that can be pledged as collateral for future borrowings from the Federal Reserve Bank and the FHLB above the current lendable collateral value. Our ability to maintain sufficient liquidity may be affected by numerous factors, including economic conditions nationally and in our markets. Depending on our liquidity levels, our capital position, conditions in the capital markets, our business operations and initiatives, and other factors, we may from time to time consider the issuance of debt, equity or other securities or other possible capital market transactions, the proceeds of which could provide additional liquidity for our operations.

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

Capital Resources

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

TABLE 14: Capital Ratios

	Actual		**Minimum Capital Requirements**		**Minimum To Be Well Capitalized Under Prompt Corrective Action Provisions**	
(Dollars in thousands)	**Amount**	**Ratio**	**Amount**	**Ratio**	**Amount**	**Ratio**
As of June 30, 2013:						
Total Capital (to Risk-Weighted Assets)						
Corporation	**$126,032**	**17.7 %**	**$56,846**	**8.0 %**	**N/A**	**N/A**
Bank	**123,614**	**17.5**	**56,608**	**8.0**	**$70,760**	**10.0 %**
Tier 1 Capital (to Risk-Weighted Assets)						
Corporation	**116,830**	**16.4**	**28,423**	**4.0**	**N/A**	**N/A**
Bank	**114,449**	**16.2**	**28,304**	**4.0**	**42,456**	**6.0**
Tier 1 Capital (to Average Assets)						
Corporation	**116,830**	**11.9**	**39,191**	**4.0**	**N/A**	**N/A**
Bank	**114,449**	**11.7**	**39,050**	**4.0**	**48,812**	**5.0**
As of December 31, 2012:						
Total Capital (to Risk-Weighted Assets)						
Corporation	$118,824	16.6 %	$57,216	8.0 %	N/A	N/A
Bank	115,892	16.3	56,970	8.0	$71,213	10.0 %
Tier 1 Capital (to Risk-Weighted Assets)						
Corporation	109,552	15.3	28,608	4.0	N/A	N/A
Bank	106,657	15.0	28,485	4.0		