FIRST MARINER BANCORP
Form 10-Q
November 14, 2013

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2013.

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

For the transition period from to

Commission file number: 0-21815

FIRST MARINER BANCORP
(Exact name of registrant as specified in its charter)

Maryland		52-1834860
(State of Incorporation)		(I.R.S. Employer Identification Number)
1501 South Clinton Street, Baltimore, MD	21224	410-342-2600
(Address of principal executive offices)	(Zip Code)	(Telephone Number)

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 during the preceding 12 months (or for such shorter period that the registrant was required to file such report, and (2) has been subject to such filing requirements for the past 90 days. Yes x No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No o (Not Applicable)

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

Large accelerated filer o Accelerated filer o Non-accelerated filer o Smaller reporting company x

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

The number of shares of common stock outstanding as of November 8, 2013 is 19,705,896 shares.

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FIRST MARINER BANCORP AND SUBSIDIARY

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CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

Some of our statements contained in, or incorporated by reference into, this Quarterly Report on Form 10-Q are "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. We intend such forward-looking statements to be covered by the safe harbor provisions for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995 and are including this statement for purposes of invoking these safe harbor provisions. Forward-looking statements are not guarantees of performance or results. When we use words like "may," "plan," "contemplate," "anticipate," "believe," "intend," "continue," "expect," "project," "predict," "estimate," "target," "could," "is likely," "should," "would," "will," and similar exp should consider them as identifying forward-looking statements, although we may use other phrasing. These forward-looking statements involve risks and uncertainties and are based on our beliefs and assumptions and on the information available to us at the time that these disclosures were prepared. These forward-looking statements involve risks and uncertainties and may not be realized due to a variety of factors, including, but not limited to, the following:

- our ability to continue to operate as a going concern;
- our ability to meet our liquidity needs, including the payment of deferred interest on our junior subordinated deferrable interest debentures upon the expiration of the permitted 20-quarter deferral period in January, 2014;
- our ability to raise sufficient capital to comply with the requirements of our regulators and for continued support of operations;
- our ability to realize the benefits from our cost saving initiatives;
- the failure of assumptions underlying the establishment of our allowance for loan losses that may prove to be materially incorrect or may not be borne out by subsequent events;
- a reduction in the value of the collateral for loans made by us, especially real estate, which, in turn would likely reduce our customers' borrowing power and the value of assets and collateral associated with our existing loans;
- increased loan delinquencies and/or an escalation in problem assets and foreclosures;
- a reduction in the value of certain assets held by us;
- the imposition of additional enforcement actions by bank regulatory authorities upon First Mariner Bank or First Mariner Bancorp;
- the success and timing of our business strategies and our ability to effectively carry out our business and capital plans;
- unanticipated regulatory or judicial proceedings;
- our ability to effectively manage market risk, credit risk, and operational risk;
- our ability to realize income through our mortgage-banking operations;
- a decline in demand for our products and services;
- our ability to attract and retain deposits;

- the timely development of competitive new products and services and the acceptance of these products and services by new and existing customers;
- changes in consumer spending and savings habits;
- our ability to retain key employees;
- our estimates of self-insurance accruals and future liability;

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- the effect of any mergers, acquisitions, or other transactions to which we or our subsidiary may from time to time be a party;
- adverse changes in the securities' markets;
- the risks of changes in interest rates on the level and composition of deposits, loan demand, and the values of loan collateral, securities, and interest-sensitive assets and liabilities;
- the effects of competition from other commercial banks, thrifts, mortgage-banking firms, consumer finance companies, credit unions, securities brokerage firms, insurance companies, money market and other mutual funds, and other financial institutions operating in our market area and elsewhere, including institutions operating regionally, nationally, and internationally, together with competitors offering banking products and services by mail, telephone, and the Internet;
- costs and potential disruption or interruption of operations due to cyber-security incidents;
- the effect of changes in accounting policies and practices, as may be adopted from time-to-time by bank regulatory agencies, the Securities and Exchange Commission, the Financial Accounting Standards Board, or other accounting standards setters;
- the effects of, and changes in, trade, monetary, and fiscal policies and laws, including interest rate policies of the Federal Reserve Board, inflation, interest rate, market, and monetary fluctuations;
- the strength of the United States economy in general, the strength of the local economies in which we conduct operations, and the unfavorable effects of future economic conditions, including inflation, recession, or decreases in real estate values;
- geopolitical conditions, including acts or threats of terrorism, actions taken by the United States or other governments in response to acts or threats of terrorism and/or military conflicts, which could impact business and economic conditions in the United States and abroad; and
- the risks described in this Quarterly Report on Form 10-Q and our Annual Report on Form 10-K as of and for the year ended December 31, 2012.

All written or oral forward-looking statements attributable to us are expressly qualified in their entirety by this Cautionary Note. Our actual results may differ significantly from those we discuss in these forward-looking statements. For other factors, risks, and uncertainties that could cause our actual results to differ materially from estimates and projections contained in these forward-looking statements, please read the "Risk Factors" in Item 1A of Part I of our Annual Report on Form 10-K as of and for the year ended December 31, 2012. Any forward-looking statement speaks only as of the date which such statement was made, and, except as required by law, we expressly disclaim any obligation or undertaking to disseminate any updates or revisions to any forward-looking statement to reflect events or circumstances after the date on which such statement is made or to reflect the occurrence of unanticipated events.

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PART I — FINANCIAL INFORMATION

Item 1 — Financial Statements

First Mariner Bancorp and Subsidiary
Consolidated Statements of Financial Condition
(dollars in thousands, except per share data)

	September 30, 2013 (unaudited)	December 31, 2012
ASSETS		
Cash and due from banks	$121,727	$169,225
Federal funds sold and interest-bearing deposits	28,935	16,556
Securities available for sale (“AFS”), at fair value	134,129	57,676
Loans held for sale (“LHFS”), at fair value	128,584	404,289
Loans receivable	560,316	610,396
Allowance for loan losses	(9,200)	(11,434)
Loans, net	551,116	598,962
Real estate acquired through foreclosure	19,368	18,058
Restricted stock investments	3,517	7,099
Premises and equipment, net	37,521	37,651
Accrued interest receivable	3,180	4,387
Bank-owned life insurance (“BOLI”)	39,354	38,601
Prepaid expenses and other assets	17,162	25,025
Total assets	$1,084,593	$1,377,529
LIABILITIES AND STOCKHOLDERS’ DEFICIT		
Liabilities:		
Deposits:		
Noninterest-bearing	$97,965	$109,966
Interest-bearing	883,300	1,076,864
Total deposits	981,265	1,186,830
Short-term borrowings	3,180	53,466
Long-term borrowings	40,000	73,515
Junior subordinated deferrable interest debentures	52,068	52,068
Accrued expenses and other liabilities (of which $179 and $248 are at fair value, respectively)	25,710	20,022
Total liabilities	1,102,223	1,385,901
Stockholders’ deficit:		
Common stock, $.05 par value; 75,000,000 shares authorized; 19,705,896 and 18,860,482 shares issued and outstanding, respectively	981	939
Additional paid-in capital	80,726	79,872
Accumulated deficit	(98,506)	(87,337)
Accumulated other comprehensive loss	(831)	(1,846)
Total stockholders’ deficit	(17,630)	(8,372)

Total liabilities and stockholders' deficit	$1,084,593	$1,377,529

See accompanying notes to consolidated financial statements

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First Mariner Bancorp and Subsidiary
Consolidated Statements of Operations
(dollars in thousands except per share data)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
	(unaudited)			
Interest income:				
Loans	$9,292	$11,567	$29,554	$33,644
Securities and other earning assets	519	352	1,312	1,063
Total interest income	9,811	11,919	30,866	34,707
Interest expense:				
Deposits	2,390	2,898	8,115	8,857
Short-term borrowings	2	35	20	99
Long-term borrowings	727	927	2,502	2,780
Total interest expense	3,119	3,860	10,637	11,736
Net interest income	6,692	8,059	20,229	22,971
Provision for loan losses	—	—	1,300	572
Net interest income after provision for loan losses	6,692	8,059	18,929	22,399
Noninterest income:				
Total other-than-temporary impairment (“OTTI”) charges	—	—	—	175
Less: Portion included in other comprehensive loss (pre-tax)	—	—	—	(635)
Net OTTI charges on AFS securities	—	—	—	(460)
Mortgage-banking revenue	548	15,384	15,703	35,450
ATM fees	558	649	1,697	2,067
Service fees on deposits	668	623	1,995	1,927
(Loss) gain on sale of AFS securities	(4)	—	51	—
Gain (loss) on disposition and sale of premises and equipment and other assets	23	(949)	20	(1,271)
Commissions on sales of nondeposit investment products	54	62	213	211
Gain on sale of minority interest in Mariner Finance	—	—	2,885	—
Income from BOLI	242	273	753	853
Other	291	238	975	717
Total noninterest income	2,380	16,280	24,292	39,494
Noninterest expense:				
Salaries and employee benefits	6,499	6,107	19,804	17,438
Occupancy	2,100	1,835	6,358	6,343
Furniture, fixtures, and equipment	467	332	1,252	1,018
Professional services	656	973	3,373	2,085
Advertising	289	189	1,066	609
Data processing	1,143	403	1,764	1,237
ATM servicing expenses	95	225	292	678
Write-downs, losses, and costs of real estate acquired through foreclosure	560	1,325	4,257	3,539
Federal Deposit Insurance Corporation (“FDIC”) insurance premiums	1,021	1,009	3,359	3,131
Service and maintenance	649	644	2,156	1,799
Corporate Insurance	776	695	2,356	1,571

Consulting fees	516	395	1,345	1,319
Postage	231	740	2,225	1,421
Other	1,701	1,541	4,998	4,492
Total noninterest expense	16,703	16,413	54,605	46,680
Net (loss) income before income taxes	(7,631)	7,926	(11,384)	15,213
Income tax benefit	(216)	—	(215)	(205)
Net (loss) income	$(7,415)	$7,926	$(11,169)	$15,418
Net (loss) income per common share - basic and diluted	$(0.38)	$0.42	$(0.58)	$0.82

See accompanying notes to consolidated financial statements.

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First Mariner Bancorp and Subsidiary
Consolidated Statements of Comprehensive (Loss) Income
(dollars in thousands)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
	(unaudited)			
Net (loss) income	$(7,415)	$7,926	$(11,169)	$15,418
Other comprehensive income items:				
Unrealized holding gains on securities arising during the period (net of tax expense of $1,742, $293, $707, and $724, respectively)	2,574	433	1,045	1,070
Reclassification adjustment for net losses (gains) on securities (net of tax (expense) benefit of $2, $0, $(21), and $186, respectively) included in net (loss) income	2	—	(30)	274
Total other comprehensive income	2,576	433	1,015	1,344
Total comprehensive (loss) income	$(4,839)	$8,359	$(10,154)	$16,762

See accompanying notes to consolidated financial statements.

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First Mariner Bancorp and Subsidiary
Consolidated Statements of Changes in Stockholders' Deficit
(dollars in thousands except per share data)

	Nine Months Ended September 30, 2013 (unaudited)					
	Number of Shares of Common Stock	Common Stock	Additional Paid-in Capital	Accumulated Deficit	Accumulated Other Comprehensive Loss	Total Stockholders' Deficit
Balance at January 1, 2013	18,860,482	$939	$79,872	$(87,337)	$ (1,846)	$(8,372)
Net loss	—	—	—	(11,169)	—	(11,169)
Common stock issued, net of costs	845,414	42	255	—	—	297
Stock-based compensation expense	—	—	530	—	—	530
Change in fair value of warrants	—	—	69	—	—	69
Changes in unrealized losses on securities, net of taxes	—	—	—	—	1,015	1,015
Balance at September 30, 2013	19,705,896	$981	$80,726	$(98,506)	$ (831)	$(17,630)

	Nine Months Ended September 30, 2012 (unaudited)					
	Number of Shares of Common Stock	Common Stock	Additional Paid-in Capital	Accumulated Deficit	Accumulated Other Comprehensive Loss	Total Stockholders' Deficit
Balance at January 1, 2012	18,860,482	$939	$80,125	$(103,454)	$ (3,022)	$(25,412)
Net income	—	—	—	15,418	—	15,418
Costs of common stock issued, net	—	—	(22)	—	—	(22)
Change in fair value of warrants	—	—	(97)	—	—	(97)
Changes in unrealized losses on securities, net of taxes	—	—	—	—	1,344	1,344
Balance at September 30, 2012	18,860,482	$939	$80,006	$(88,036)	$ (1,678)	$(8,769)

See accompanying notes to consolidated financial statements.

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First Mariner Bancorp and Subsidiary
Consolidated Statements of Cash Flows
(dollars in thousands)

	Nine Months Ended September 30,	
	2013	2012
	(unaudited)	
Cash flows from operating activities:		
Net (loss) income	$(11,169)	$15,418
Adjustments to reconcile net (loss) income to net cash from operating activities:		
Depreciation and amortization	2,171	2,043
(Accretion) amortization of unearned loan fees and costs, net	(30)	496
Amortization of discounts on mortgage-backed securities, net	36	6
Origination fees and gains on sale of mortgage loans	(14,514)	(33,615)
Net OTTI charges on AFS securities	—	460
Gain on sale of AFS securities	(51)	—
Gain on sale of minority interest in Mariner Finance	(2,885)	—
(Gain) loss on disposition and sale of premises and equipment and other assets	(20)	1,271
Decrease in accrued interest receivable	1,207	10
Provision for loan losses	1,300	572
Write-downs and losses on sale of real estate acquired through foreclosure	2,793	1,818
Increase in cash surrender value of BOLI	(753)	(853)
Originations of mortgage LHFS	(1,727,355)	(1,773,267)
Proceeds from sales of mortgage LHFS	2,004,646	1,617,977
Net increase in accrued expenses and other liabilities	3,606	5,736
Net decrease (increase) in prepaids and other assets	6,062	(4,283)
Net cash provided by (used in) operating activities	265,044	(166,211)
Cash flows from investing activities:		
Loan principal repayments, net	37,939	49,315
Sales of held-for-investment loans	10,536	—
Repurchase of loans previously sold	(1,307)	(827)
Sale of restricted stock investments	3,582	256
Proceeds from disposal of premises and equipment	648	—
Purchases of premises and equipment	(2,670)	(2,571)
Activity in AFS securities:		
Maturities/calls/repayments	12,415	9,217
Sales	4,511	—
Purchases	(88,681)	(29,001)
Proceeds from sales of real estate acquired through foreclosure	8,232	9,722
Proceeds from sale of minority interest in Mariner Finance	4,000	—
Net cash (used in) provided by investing activities	(10,795)	36,111
Cash flows from financing activities:		
Net (decrease) increase in deposits	(205,566)	93,392
Net decrease in other borrowed funds	(83,802)	(852)
Net costs of stock issuance	—	(22)
Net cash (used in) provided by financing activities	(289,368)	92,518
Decrease in cash and cash equivalents	(35,119)	(37,582)
Cash and cash equivalents at beginning of period	185,781	148,789

Cash and cash equivalents at end of period	$150,662	$111,207
Supplemental information:		
Interest paid on deposits and borrowed funds	$9,571	$10,522
Real estate acquired in satisfaction of loans	$12,335	$6,283
Transfers of LHFS to loan portfolio	$12,928	$342

See accompanying notes to consolidated financial statements

First Mariner Bancorp and Subsidiary
Notes to Consolidated Financial Statements
(Information as of and for the three and
nine months ended September 30, 2013 and 2012 is unaudited)

(1) Summary of Significant Accounting Policies

Basis of Presentation

The accompanying consolidated financial statements for First Mariner Bancorp have been prepared in accordance with the instructions for Form 10-Q and, therefore, do not include all information and notes necessary for a full presentation of financial condition, results of operations, and cash flows in conformity with accounting principles generally accepted in the United States of America ("U.S.") ("GAAP"). The consolidated financial statements should be read in conjunction with the audited financial statements included in First Mariner Bancorp's Annual Report on Form 10-K as of and for the year ended December 31, 2012. When used in these notes, the terms "the Company," "we," "us," and "our" refer to First Mariner Bancorp and, unless the context requires otherwise, its consolidated subsidiary.

The consolidated financial statements include the accounts of First Mariner and its wholly owned subsidiary, First Mariner Bank (the "Bank"). All significant intercompany accounts and transactions have been eliminated in consolidation. Events occurring after the date of the financial statements were considered in the preparation of the financial statements. Certain reclassifications have been made to amounts previously reported to conform to classifications made in 2013.

The consolidated financial statements as of September 30, 2013 and for the three and nine months ended September 30, 2013 and 2012 are unaudited but include all adjustments, consisting only of normal recurring adjustments, which we consider necessary for a fair presentation of financial position and results of operations for those periods. The results of operations for the three and nine months ended September 30, 2013 are not necessarily indicative of the results that will be achieved for the entire year or any future interim period.

The preparation of the financial statements in conformity with GAAP requires management to make estimates and judgments that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of 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"), loan repurchases and related valuations, real estate acquired through foreclosure, impairment of AFS securities, valuations of financial instruments, and deferred income taxes. In connection with these determinations, management evaluates historical trends and ratios and, where appropriate, obtains independent appraisals for significant properties and prepares fair value analyses. Actual results could differ significantly from those estimates.

(2) Going Concern Consideration

Due to the conditions and events discussed later in Note 5, there is substantial doubt regarding our ability to continue as a going concern. Management is taking various steps designed to improve the Company's and the Bank's capital position. The Bank has developed a written alternative capital plan designed to improve the Bank's capital ratios. Such plan is dependent upon a capital infusion to meet the capital requirements of the various regulatory agreements (see Note 5 for more information on the agreements). The Company continues to work with its advisors in an attempt to improve capital ratios.

The consolidated financial statements presented above and the accompanying Notes have been prepared on a going concern basis, which contemplates the realization of assets and the discharge of liabilities in the normal course of business for the foreseeable future, and does not include any adjustment to reflect the possible future effects on the recoverability and classification of assets, or the amounts and classification of liabilities that may result from the outcome of any extraordinary regulatory action, which would affect our ability to continue as a going concern.

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(3) Securities

The composition of our securities portfolio (all AFS) is as follows:

	September 30, 2013			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Estimated Fair Value
	(dollars in thousands)			
Mortgage-backed securities	$54,766	$564	$643	$54,687
Trust preferred securities	6,111	497	337	6,271
U.S. government agency notes	69,411	78	665	68,824
U.S. Treasury securities	2,762	3	—	2,765
Equity securities - banks	1,175	—	346	829
Equity securities - mutual funds	750	3	—	753
	$134,975	$1,145	$1,991	$134,129

	December 31, 2012			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Estimated Fair Value
	(dollars in thousands)			
Mortgage-backed securities	$7,040	$169	$75	$7,134
Trust preferred securities	11,246	79	2,144	9,181
U.S. government agency notes	33,435	107	5	33,537
U.S. Treasury securities	5,779	2	—	5,781
Equity securities - banks	1,288	16	48	1,256
Equity securities - mutual funds	750	37	—	787
	$59,538	$410	$2,272	$57,676

Contractual maturities of debt securities at September 30, 2013 are shown below. Actual maturities may differ from contractual maturities because borrowers have the right to call or prepay obligations with or without call or prepayment penalties.

	Amortized Cost	Estimated Fair Value
	(dollars in thousands)	
Due in one year or less	$36,364	$36,075
Due after one year through five years	33,809	33,575
Due after five years through ten years	2,000	1,939
Due after ten years	6,111	6,271
Mortgage-backed securities	54,766	54,687
	$133,050	$132,547

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The following tables show the level of our gross unrealized losses and the fair value of the associated securities by type and maturity for AFS securities:

	September 30, 2013					
	Less than 12 months		12 months or more		Total	
	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses
	(dollars in thousands)					
Mortgage-backed securities	$27,090	$553	$1,761	$90	$28,851	$643
Trust preferred securities	—	—	5,129	337	5,129	337
U.S. government agency notes	39,557	665	—	—	39,557	665
Equity securities - banks	829	346	—	—	829	346
	$67,476	$1,564	$6,890	$427	$74,366	$1,991

	December 31, 2012					
	Less than 12 months		12 months or more		Total	
	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses
	(dollars in thousands)					
Mortgage-backed securities	$3,552	$75	$—	$—	$3,552	$75
Trust preferred securities	—	—	5,027	2,144	5,027	2,144
U.S. government agency notes	9,139	5	—	—	9,139	5
Equity securities - banks	1,035	47	123	1	1,158	48
	$13,726	$127	$5,150	$2,145	$18,876	$2,272

The trust preferred securities that we hold in our securities portfolio are issued by other banks, bank holding companies, and insurance companies. Certain of these securities have experienced declines in value since acquisition. These declines have occurred due to changes in the market which has limited the demand for these securities and reduced their liquidity. We consider the decline in value for four pooled trust preferred securities to be other than temporary and recorded the credit-related portion of the impairment as net OTTI of $460,000 during the nine months ended September 30, 2012. No additional OTTI charges were required during 2013. See additional information on the pooled trust preferred securities in Note 9.

The following shows the activity in OTTI related to credit losses for the nine months ended September 30:

	2013	2012
	(dollars in thousands)	
Balance at beginning of period	$9,190	$8,730
Additional OTTI taken for credit losses	—	460
Balance at end of period	$9,190	$9,190

All of the remaining securities that are impaired are so due to declines in fair values resulting from changes in interest rates or increased credit/liquidity spreads since the time they were purchased. We have the intent to hold these debt securities to maturity, and, for debt and equity securities in a loss position, for the foreseeable future and do not intend, nor do we believe it is more likely than not, that we will be required to sell the securities before anticipated recovery. We expect these securities will be repaid in full, with no losses realized. As such, management considers the impairments to be temporary.

At September 30, 2013, we held securities with an aggregate carrying value (fair value) of $51.4 million that we have pledged as collateral for certain mortgage-banking and hedging activities, borrowings, government deposits, and customer deposits.

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(4) Loans Receivable (Financing Receivables) and Allowance for Loan Losses

Loans receivable are summarized as follows:

	September 30, 2013	December 31, 2012
	(dollars in thousands)	
Commercial	$48,789	$47,976
Commercial mortgage	222,782	263,666
Commercial construction	48,595	49,872
Consumer construction	19,834	19,005
Residential mortgage	111,640	111,314
Consumer	109,838	119,802
Total loans	561,478	611,635
Unearned loan fees, net	(1,162)	(1,239)
	$560,316	$610,396

Included in consumer loan totals in the above table are overdrawn commercial and retail checking accounts totaling $299,000 as of September 30, 2013 and $919,000 as of December 31, 2012.

Transferred Loans

In accordance with the Financial Accounting Standards Board ("FASB") guidance on mortgage-banking activities, any loan which is originally originated for sale into the secondary market and which we subsequently elect to transfer into the Company's loan portfolio is valued at fair value at the time of the transfer with any decline in value recorded as a charge against earnings.

Information on the activity in transferred loans and related accretable yield is as follows for the three months ended September 30:

	Loan Balance		Accretable Yield		Total	
	2013	2012	2013	2012	2013	2012
	(dollars in thousands)					
Beginning balance	$19,257	$10,873	$144	$36	$19,113	$10,837
Loans transferred	5,647	—	—	—	5,647	—
Charge-offs	(703)	(781)	(13)	(4)	(690)	(777)
Payments/sales/accretion	(1,754)	(1,625)	(8)	(8)	(1,746)	(1,617)
Ending balance	$22,447	$8,467	$123	$24	$22,324	$8,443

Information on the activity in transferred loans and related accretable yield is as follows for the nine months ended September 30:

	Loan Balance		Accretable Yield		Total	
	2013	2012	2013	2012	2013	2012
	(dollars in thousands)					
Beginning balance	$17,501	$14,008	$220	$266	$17,281	$13,742
Loans transferred	12,928	342	—	—	12,928	342
Charge-offs	(703)	(1,066)	(13)	(18)	(690)	(1,048)
Payments/sales/accretion	(7,279)	(4,817)	(84)	(224)	(7,195)	(4,593)
Ending balance	$22,447	$8,467	$123	$24	$22,324	$8,443

At September 30, 2013, we had pledged loans with a carrying value of $89.2 million as collateral for Federal Home Loan Bank ("FHLB") advances.

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Credit Quality

Management has an established methodology to determine the adequacy of the allowance for loan losses that assesses the risks and losses inherent in the loan portfolio. For purposes of determining the allowance for loan losses, we have segmented our loan portfolio by product type. Our portfolio loan segments are commercial, commercial mortgage, commercial construction, consumer construction, residential mortgage, and consumer. We have looked at all segments to determine if subcategorization into classes is warranted based upon our credit review methodology and have divided consumer loans into two classes, (1) home equity and second mortgage loans and (2) other consumer loans.

To establish the allocated portion of the allowance for loan losses, loans are pooled by portfolio class and an historical loss percentage is applied to each class. The historical loss percentage is based upon a rolling 24-month history, which gives us the most relevant charge-off data. The result of that calculation for each loan class is then applied to the current loan portfolio balances to determine the required allocated portion of the allowance for loan loss level per loan class. We then apply additional loss multipliers to the different classes of loans to reflect various environmental factors. This amount is considered our unallocated allowance. These factors capture any changes in economic trends, portfolio composition, real estate trends, as well as other factors and are meant to supplement the required allocated allowance. For individually evaluated loans (impaired loans), we do additional analyses to determine the impairment amount. In general, this impairment is included as part of the allocated allowance for loan losses for troubled debt restructures ("TDR" or "TDRs") and is charged off for all other impaired loans. These loss estimates are performed under multiple economic scenarios to establish a range of potential outcomes for each criterion. Management applies judgment to develop its own view of loss probability within that range, using external and internal parameters with the objective of establishing an allowance for loss inherent within these portfolios as of the reporting date.

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The following tables present, by portfolio segment, the changes in the allowance for loan losses, and the recorded investment in loans:

	Three Months Ended September 30, 2013							
	Commercial	Commercial Mortgage	Commercial Construction	Consumer Construction	Residential Mortgage	Consumer	Unallocated	Total
	(dollars in thousands)							
Beginning Balance	$1,162	$1,534	$238	$84	$2,058	$1,588	$3,212	$9,876
Charge-offs	—	—	(1,196)	—	(136)	(129)	—	(1,461)
Recoveries	6	14	—	61	626	78	—	785
Net recoveries (charge-offs)	6	14	(1,196)	61	490	(51)	—	(676)
(Reversal of) provision for loan losses	(852)	(554)	1,665	(106)	(947)	(174)	968	—
Ending Balance	$316	$994	$707	$39	$1,601	$1,363	$4,180	$9,200

	Nine Months Ended September 30, 2013							
	Commercial	Commercial Mortgage	Commercial Construction	Consumer Construction	Residential Mortgage	Consumer	Unallocated	Total
	(dollars in thousands)							
Beginning Balance	$2,070	$1,254	$414	$20	$1,774	$2,040	$3,862	$11,434
Charge-offs	(129)	(1,087)	(1,330)	(148)	(1,842)	(497)	—	(5,033)
Recoveries	99	163	—	61	952	224	—	1,499
Net charge-offs	(30)	(924)	(1,330)	(87)	(890)	(273)	—	(3,534)
(Reversal of) provision for loan losses	(1,724)	664	1,623	106	717	(404)	318	1,300
Ending Balance	$316	$994	$707	$39	$1,601	$1,363	$4,180	$9,200
Ending balance - individually evaluated for impairment	$96	$30	$—	$—	$117	$—	$—	$243
Ending balance - collectively evaluated for impairment	220	964	707	39	1,484	1,363	4,180	8,957
	$316	$994	$707	$39	$1,601	$1,363	$4,180	$9,200
Ending loan balance - individually evaluated for impairment	$13,416	$19,646	$11,877	$426	$14,955	$1,435		$61,755
Ending loan balance - collectively	35,283	203,122	36,698	19,181	96,829	107,448		498,561

evaluated for impairment	$48,699	$222,768	$48,575	$19,607	$111,784	$108,883		$560,316

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	Three Months Ended September 30, 2012							
	Commercial	Commercial Mortgage	Commercial Construction	Consumer Construction	Residential Mortgage	Consumer	Unallocated	Total
	(dollars in thousands)							
Beginning Balance	$2,897	$1,562	$1,678	$130	$1,504	$2,250	$3,501	$13,522
Charge-offs	—	(253)	(206)	—	(365)	(638)	—	(1,462)
Recoveries	—	—	—	—	5	31	—	36
Net charge-offs	—	(253)	(206)	—	(360)	(607)	—	(1,426)
(Reversal of) provision for loan losses	(901)	299	(992)	91	434	391	678	—
Ending Balance	$1,996	$1,608	$480	$221	$1,578	$2,034	$4,179	$12,096

	Nine Months Ended September 30, 2012							
	Commercial	Commercial Mortgage	Commercial Construction	Consumer Construction	Residential Mortgage	Consumer	Unallocated	Total
	(dollars in thousands)							
Beginning Balance	$2,768	$2,011	$1,809	$156	$2,711	$2,632	$1,714	$13,801
Charge-offs	(187)	(573)	(353)	(7)	(879)	(1,576)	—	(3,575)
Recoveries	—	612	52	—	425	209	—	1,298
Net (charge-offs) recoveries	(187)	39	(301)	(7)	(454)	(1,367)	—	(2,277)
(Reversal of) provision for loan losses	(585)	(442)	(1,028)	72	(679)	769	2,465	572
Ending Balance	$1,996	$1,608	$480	$221	$1,578	$2,034	$4,179	$12,096
Ending balance - individually evaluated for impairment	$149	$24	$—	$—	$202	$—	$—	$375
Ending balance - collectively evaluated for impairment	1,847	1,584	480	221	1,376	2,034	4,179	11,721
	$1,996	$1,608	$480	$221	$1,578	$2,034	$4,179	$12,096
Ending loan balance - individually evaluated for impairment	$9,872	$32,810	$11,652	$655	$17,740	$936		$73,665
Ending loan balance - collectively evaluated for	35,845	263,464	36,667	18,231	95,075	120,521		569,803

impairment	$45,717	$296,274	$48,319	$18,886	$112,815	$121,457		$643,468

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We use creditworthiness categories to grade commercial loans. Our internal grading system is based on experiences with similarly graded loans. Category ratings are reviewed each quarter. Our internal risk ratings are as follows:

Superior Credit Quality ("RR1") — This category includes credits that are secured by up to 95% advance against cash balances, municipal or corporate bonds carrying an A rating or better (subject to maturity), U.S. Government securities (subject to maturity), and fully marketable securities of companies with an A or better debt rating. In addition, the borrower must have a reasonable financial condition evidenced by complete financial statements.

High Credit Quality ("RR2") — This category includes credits that are secured by up to 70% advance against municipal or corporate bonds carrying an A rating or better, U.S. Government securities, and marketable securities of companies with an A or better debt rating. For individual credits, the credit must be secured by any of the aforementioned items or first deed of trust on residential owner-occupied property with a loan-to-value ("LTV") ratio of 80% or less and adequate cash flow to service the debt. Permanent real estate loans on fully-leased properties with A-rated tenants and a 70% or less LTV ratio with income coverage of 1.25 times or higher may qualify for this rating, with confirmation of tenants' financial condition. No commercial construction loans may carry this rating at inception. At September 30, 2013 and December 31, 2012, none of our loans carried this risk rating.

Above Average Credit Quality ("RR3") — This category includes business loans to publicly traded companies with a B rating or better, commercial construction loans with a contingent-free take-out or substantial pre-leasing (75% or more of leasable space) with an LTV ratio of 75% or less, residential construction loans with pre-sold units and an LTV ratio of 70% or less as long as sales are on a noncontingent basis and the overall project is progressing on schedule as originally determined, loans to individuals with liquid assets and strong net worth and the additional ability to service the debt from sources unrelated to the purpose of the credit extension, and monitored credits to borrowers of sound financial condition with approved advance rates providing adequate margin so that collateral can be easily liquidated within 90 days or less.

Average/Satisfactory Credit Quality ("RR4") — In general, this category includes small-to-medium sized companies with satisfactory financial condition, cash flow, profitability, and balance sheet and income statement ratios, term loans and revolving credits with annual clean-up requirements, the majority of retail commercial credits, loans to partnerships or small businesses, most wholesale sales finance lines, wholesale distributors whose capital position and profitability are at Risk Management Association averages, and loans to individuals with acceptable financial condition and sufficient net cash flow to service the debt as long as the source of repayment is identifiable and sufficient to liquidate the debt within an acceptable period of time and a secondary source of repayment is evident.

Acceptable With Care ("RR5") — This category includes secured loans to small- or medium-sized companies which have suffered a financial setback where a convincing plan for correction demonstrates the deficiency is temporary in nature, loans with debt service coverage ratios below or LTV ratios above policy guidelines, most construction and development loans, permanent loans underwritten based on pro forma rents as opposed to historical or actual rents, real estate loans where the project is moderately off the original projections as to cost estimates or absorption, and loans where the interest reserve is no longer adequate but the customer or guarantor has a proven ability to carry the interest expense out of pocket for an extended time period without undue financial strain. These credits require additional attention by the account officer and/or loan administration.

Watch Credits ("RR6") — This category includes loans to borrowers who have experienced a temporary setback or deterioration in financial condition that should correct itself during the next twelve months, companies whose financial condition has been marginally acceptable for a period of time and prospects for significant improvement are limited, loans to individuals with marginal financial condition, and most credits for start-up operations. Also included in this category are real estate loans where the project is moderately off original projections, interest reserve may be

depleted, with the borrower or guarantor having a questionable or unproved ability to pay interest out of pocket. Such loans may have modest cost overruns that will cause a shortage in the budget, raising question as to how the project will be completed. These loans may have a good collateral position, additional collateral, or strong guarantors to mitigate the risk. These credits are considered marginally acceptable, and greater than usual attention is warranted by the account officer and/or loan administration.

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Special Mention ("RR7") — special mention credits are characterized as adequately covered by collateral (if any) and/or the paying capacity of the borrower, but are subject to one or more deteriorating trends. These credits constitute an undue and unwarranted credit risk, but not to the point of justifying a classification of substandard. These credits have potential weaknesses which, if not examined and corrected, may weaken the asset or inadequately protect the Bank's credit position at some future date. This category should not be used to list assets that bear risks usually associated with the particular type of financing. Assets with this rating may have the potential for significant weakness. Loans where weaknesses are evident and significant must be considered for more serious criticism. Examples of credits carried in special mention may include the following:

- loans which are fully covered by collateral and cash flow, but where margins are inadequate;
- loans to borrowers with a strong capital base, who are experiencing modest losses;
- loans to borrowers with very strong cash flows, but experiencing modest losses;
- credits that are subject to manageable, but excessive, leverage;
- credits with material collateral documentation exceptions, but which appear to be strong credits;
- credits to customers who have not provided the Bank with current or satisfactory financial data (unless the credit is secured by liquid marketable collateral or guaranteed by financially sound parties);
- credits that the account officer may be unable to supervise properly because of a lack of expertise or lack of control over the collateral and/or its condition;
- loans with deficient documentation or other deviations from prudent lending practices; and
- loans with strong guarantors and/or secondary sources of cash flow are the support for repayment.

Substandard ("RR8") — Substandard loans are inadequately protected by the current sound worth and paying capacity of the obligor or the collateral pledged, if any. Loans so classified have a well-defined weakness or weaknesses, which jeopardize the orderly liquidation of the debt. They are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected. The borrower's financial condition indicates an inability to repay, even if restructured. Prospects for improvement in the borrower's financial condition are poor. Primary repayment source appears to be shifting from cash flow to liquidation of collateral. Examples of substandard credits may include the following:

- credits adequately covered by collateral value, where repayment is dependent upon the sale of nonliquid collateral, nontrading assets, or from guarantors;
- loans secured by collateral greater than the amount of the credit, but where cash flow is inadequate to amortize the debt over a reasonable period of time;
- credits with negative financial trends coupled with material collateral documentation deficiencies or where there is a high potential for loss of principal;
- unsecured loans to borrowers whose financial condition does not warrant unsecured advances;

- credits where the borrower is in bankruptcy or the work out effort is proceeding toward legal remedies including foreclosure; and

- all nonaccrual loans.

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Doubtful ("RR9") — Doubtful classifications have all the weaknesses inherent in those classified substandard with the added characteristic that the weaknesses make collection or liquidation in full on the basis of currently known facts, conditions, and values highly questionable and improbable. A doubtful classification may be appropriate in cases where significant risk exposures are perceived, but loss cannot be determined because of specific, reasonable, and pending factors which may strengthen and work to the advantage of the credit in the near term. Account officers attempt to identify any principal loss in the credit, where possible, thereby limiting the excessive use of the doubtful classification. The classification is a deferral of the estimated loss until its more exact status may be determined. Pending factors include proposed mergers, acquisition or liquidation procedures, new capital injection, perfecting liens on additional collateral, and refinancing plans. At September 30, 2013 and December 31, 2012, none of our loans carried this risk rating.

Loss ("RR10") — Losses must be taken as soon as they are realized. In some instances and on a temporary basis, a portion of a loan may receive this rating (split rating) when the actual loss cannot be currently identified. In these instances, additional facts or information is necessary to determine the final amount to be charged against the allowance. When applied for these purposes, this risk rating may be used for a period not to exceed six months. Subsequent to the identification of this split rating, the remaining balance will be risk rated substandard. This category includes advances in excess of calculated current fair value which are considered uncollectible and do not warrant continuance as bankable assets. This classification does not mean that the loan has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may occur in the future. Credits to distressed borrowers lacking an identifiable and realistic source of repayment are generally charged off. Loans where repayment is dependent upon events that are not predictable in terms of result or timing (such as protracted litigation) are generally charged off. At September 30, 2013 and December 31, 2012, none of our loans carried this risk rating.

Insufficient Information to Rate ("RRX") — This rating is designed to be a temporary rating until sufficient information is provided to properly evaluate the risk and assign a permanent rating. If adequate information is not provided in a timely manner, this credit will receive a minimum rating of RR6, requiring quarterly reporting go the Watch Committee. At September 30, 2013 and December 31, 2012, none of our loans carried this risk rating.

The following table shows the credit quality breakdown of our commercial loan portfolio by class as of September 30, 2013 and December 31, 2012:

	Commercial		Commercial Mortgage		Commercial Construction		Consumer Construction		Total	
	2013	2012	2013	2012	2013	2012	2013	2012	2013	2012
	(dollars in thousands)									
RR8	$2,696	$2,678	$10,648	$26,262	$16,651	$10,708	$—	$—	$29,995	$39,648
RR7	8,047	7,268	22,247	17,174	3,124	10,355	—	—	33,418	34,797
RR6	10,395	9,966	43,947	48,754	14,119	15,151	—	—	68,461	73,871
RR5	17,936	16,008	90,658	101,312	14,681	12,781	—	—	123,275	130,101
RR4	9,601	11,971	52,217	67,044	—	907	19,607	18,837	81,425	98,759
RR3	—	—	3,051	3,168	—	—	—	—	3,051	3,168
RR1	24	16	—	—	—	—	—	—	24	16
	$48,699	$47,907	$222,768	$263,714	$48,575	$49,902	$19,607	$18,837	$339,649	$380,360

We do not individually grade residential mortgage or consumer loans. Such loans are classified as performing or nonperforming. Loan performance is reviewed each quarter. The following table shows performing and nonperforming (nonaccrual) residential mortgage and consumer loans by class as of September 30, 2013 and December 31, 2012:

	Residential Mortgage		Home Equity & 2nd Mortgage		Other Consumer		Total	
	2013	2012	2013	2012	2013	2012	2013	2012
	(dollars in thousands)							
Nonaccrual loans	$5,615	$8,826	$ 1,265	$ 961	$170	$12	$7,050	$9,799
Performing loans	106,169	102,519	90,594	100,844	16,854	16,874	213,617	220,237
	$111,784	$111,345	$ 91,859	$ 101,805	$17,024	$16,886	$220,667	$230,036

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The following tables show the aging of our loans receivable by class. Also included are loans that are 90 days or more past due as to interest and principal and still accruing because they are well-secured and in the process of collection.

	September 30, 2013						
	30-59 Days Past Due	60-89 Days Past Due	90 Days or More Past Due	Total Past Due	Current	Total Loans	90 Days or More and Accruing
	(dollars in thousands)						
Commercial	$193	$74	$370	$637	$48,062	$48,699	$—
Commercial mortgage	5,530	7,876	8,375	21,781	200,987	222,768	1,997
Commercial construction	93	—	6,089	6,182	42,393	48,575	—
Consumer construction	—	139	426	565	19,042	19,607	—
Residential mortgage	—	2,285	7,005	9,290	102,494	111,784	1,390
Home equity and 2nd mortgage	2,026	3,263	1,316	6,605	85,254	91,859	51
Other consumer	19	—	170	189	16,835	17,024	—
	$7,861	$13,637	$23,751	$45,249	$515,067	$560,316	$3,438

	December 31, 2012						
	30-59 Days Past Due	60-89 Days Past Due	90 Days or More Past Due	Total Past Due	Current	Total Loans	90 Days or More and Accruing
	(dollars in thousands)						
Commercial	$221	$—	$2,110	$2,331	$45,576	$47,907	$—
Commercial mortgage	8,233	1,698	21,269	31,200	232,514	263,714	—
Commercial construction	2,127	—	4,637	6,764	43,138	49,902	—
Consumer construction	1,075	331	645	2,051	16,786	18,837	—
Residential mortgage	6,847	7,650	9,048	23,545	87,800	111,345	222
Home equity and 2nd mortgage	1,287	416	961	2,664	99,141	101,805	—
Other consumer	13	7	12	32	16,854	16,886	—
	$19,803	$10,102	$38,682	$68,587	$541,809	$610,396	$222

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Impaired loans include nonaccrual loans and TDRs. The following tables show the breakout of impaired loans by class:

	September 30, 2013			Nine Months Ended September 30, 2013			2012		
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized	Charge-Offs	Average Recorded Investment	Interest Income Recognized	Charge-Offs
	(dollars in thousands)								
With no related allowance:									
Commercial	$6,136	$6,136	$ —	$4,444	$ 79	$129	$3,895	$ 38	$187
Commercial mortgage	$17,909	$17,909	$ —	$25,936	$ 228	$1,087	$24,772	$ 409	$573
Commercial construction	$11,877	$11,877	$ —	$11,071	$ 139	$1,330	$13,091	$ 85	$353
Consumer construction	$426	$426	$ —	$477	$ 5	$148	$654	$ 22	$7
Residential mortgage	$9,362	$9,362	$ —	$10,525	$ 209	$1,695	$9,484	$ 191	$711
Home equity & 2nd mortgage	$1,265	$1,265	$ —	$1,124	$ 13	$497	$990	$ 20	$1,576
Other consumer	$170	$170	$ —	$93	$ 11	$—	$7	$ —	$—
With a related allowance:									
Commercial	7,184	7,280	96	7,167	98	—	1,901	103	—
Commercial mortgage	1,707	1,737	30	1,798	25	—	4,137	35	—
Commercial construction	—	—	—	—	—	—	—	—	—
Consumer construction	—	—	—	—	—	—	—	—	—
Residential mortgage	5,476	5,593	117	5,860	169	147	8,363	322	168
Home equity & 2nd mortgage	—	—	—	—	—	—	—	—	—
Other consumer	—	—	—	—	—	—	—	—	—
Total:									
Commercial	$13,320	$13,416	$ 96	$11,611	$ 177	$129	$5,796	$ 141	$187
Commercial mortgage	$19,616	$19,646	$ 30	$27,734	$ 253	$1,087	$28,909	$ 444	$573
Commercial construction	$11,877	$11,877	$ —	$11,071	$ 139	$1,330	$13,091	$ 85	$353
Consumer construction	$426	$426	$ —	$477	$ 5	$148	$654	$ 22	$7
Residential mortgage	$14,838	$14,955	$ 117	$16,385	$ 378	$1,842	$17,847	$ 513	$879
Home equity & 2nd mortgage	$1,265	$1,265	$ —	$1,124	$				