PEOPLES BANCORP OF NORTH CAROLINA INC
Form 10-Q
May 10, 2013

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

FORM 10-Q

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

For the quarterly period ended: March 31, 2013

OR

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

For the transition period from __________ to __________

PEOPLES BANCORP OF NORTH CAROLINA, INC.
(Exact name of registrant as specified in its charter)

North Carolina
(State or other jurisdiction of incorporation or organization)

000-27205 (Commission File No.)	56-2132396 (IRS Employer Identification No.)
518 West C Street, Newton, North Carolina (Address of principal executive offices)	28658 (Zip Code)

(828) 464-5620
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes X 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 X No

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

Large Accelerate Filer	Accelerated Filer	Non-Accelerated Filer

Smaller Reporting Company	X

Indicate by check mark whether the registrant is a shell company (as defined in Exchange Act Rule 12b-2 of the Exchange Act).

Yes   No X

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date.
5,613,495 shares of common stock, outstanding at April 30, 2013.

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Statements made in this Form 10-Q, other than those concerning historical information, should be considered forward-looking statements pursuant to the safe harbor provisions of the Securities Exchange Act of 1934 and the

Private Securities Litigation Act of 1995. These forward-looking statements involve risks and uncertainties and are based on the beliefs and assumptions of management and on the information available to management at the time that this Form 10-Q was prepared. These statements can be identified by the use of words like “expect,” “anticipate,” “estimate,” and “believe,” variations of these words and other similar expressions. Readers should not place undue reliance on forward-looking statements as a number of important factors could cause actual results to differ materially from those in the forward-looking statements. Factors that could cause actual results to differ materially include, but are not limited to, (1) competition in the markets served by Peoples Bank, (2) changes in the interest rate environment, (3) general national, regional or local economic conditions may be less favorable than expected, resulting in, among other things, a deterioration in credit quality and the possible impairment of collectibility of loans, (4) legislative or regulatory changes, including changes in accounting standards, (5) significant changes in the federal and state legal and regulatory environments and tax laws, (6) the impact of changes in monetary and fiscal policies, laws, rules and regulations and (7) other risks and factors identified in other filings with the Securities and Exchange Commission, including but not limited to those described in Peoples Bancorp of North Carolina, Inc.’s Annual Report on Form 10-K for the year ended December 31, 2012.

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

Consolidated Balance Sheets

March 31, 2013 and December 31, 2012

(Dollars in thousands)

Assets		March 31, 2013 (Unaudited)	December 31, 2012 (Audited)
Cash and due from banks, including reserve requirements of $10,811 and $9,625	$	19,754	32,617
Interest bearing deposits		52,624	16,226
Cash and cash equivalents		72,378	48,843
Investment securities available for sale		293,925	297,823
Other investments		5,215	5,599
Total securities		299,140	303,422
Mortgage loans held for sale		3,834	6,922
Loans		609,965	619,974
Less allowance for loan losses		(14,412)	(14,423)
Net loans		595,553	605,551
Premises and equipment, net		16,616	15,874
Cash surrender value of life insurance		13,379	13,273
Other real estate		4,588	6,254
Accrued interest receivable and other assets		12,792	13,377
Total assets	$	1,018,280	1,013,516
Liabilities and Shareholders' Equity			
Deposits:			
Non-interest bearing demand	$	168,156	161,582
NOW, MMDA & savings		378,755	371,719
Time, $100,000 or more		127,772	134,733
Other time		109,149	113,491
Total deposits		783,832	781,525
Securities sold under agreements to repurchase		37,388	34,578
FHLB borrowings		70,000	70,000
Junior subordinated debentures		20,619	20,619

Accrued interest payable and other liabilities		8,163	9,047
Total liabilities		920,002	915,769
Commitments			
Shareholders' equity:			
Series A preferred stock, $1,000 stated value; authorized			
5,000,000 shares; issued and outstanding			
12,524 shares in 2013 and 2012		12,524	12,524
Common stock, no par value; authorized			
20,000,000 shares; issued and outstanding			
5,613,495 shares in 2013 and 2012		48,133	48,133
Retained earnings		32,911	31,478
Accumulated other comprehensive income		4,710	5,612
Total shareholders' equity		98,278	97,747
Total liabilities and shareholders' equity	$	1,018,280	1,013,516
See accompanying Notes to Consolidated Financial Statements.			

PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

Consolidated Statements of Earnings

Three Months Ended March 31, 2013 and 2012

(Dollars in thousands, except per share amounts)

		2013 (Unaudited)	2012 (Unaudited)
Interest income:			
Interest and fees on loans	$	7,640	8,425
Interest on due from banks		12	3
Interest on investment securities:			
U.S. Government sponsored enterprises		378	1,070
State and political subdivisions		984	800
Other		89	64
Total interest income		9,103	10,362
Interest expense:			
NOW, MMDA & savings deposits		218	344
Time deposits		467	1,032
FHLB borrowings		661	690
Junior subordinated debentures		100	113
Other		17	39
Total interest expense		1,463	2,218
Net interest income		7,640	8,144
Provision for loan losses		1,053	2,049
Net interest income after provision for loan losses		6,587	6,095
Non-interest income:			
Service charges		1,039	1,188
Other service charges and fees		373	341
Gain on sale of securities		263	527
Mortgage banking income		384	226
Insurance and brokerage commissions		139	135
Gain/(Loss) on sale and write-down of			
other real estate		12	(189)
Miscellaneous		1,217	1,152
Total non-interest income		3,427	3,380
Non-interest expense:			
Salaries and employee benefits		4,190	3,841
Occupancy		1,312	1,301

Other		2,236	2,129
Total non-interest expense		7,738	7,271
Earnings before income taxes		2,276	2,204
Income tax expense		518	545
Net earnings		1,758	1,659
Dividends and accretion of preferred stock		157	348
Net earnings available to common shareholders	$	1,601	1,311
Basic net earnings per common share	$	0.29	0.24
Diluted net earnings per common share	$	0.29	0.24
Cash dividends declared per common share	$	0.03	0.07

See accompanying Notes to Consolidated Financial Statements.

PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

Consolidated Statements of Comprehensive Income

Three Months Ended March 31, 2013 and 2012

(Dollars in thousands)

	2013 (Unaudited)	2012 (Unaudited)
Net earnings	$ 1,758	1,659
Other comprehensive (loss) income:		
Unrealized holding (loss) gains on securities available for sale	(1,214)	1,216
Reclassification adjustment for gains on securities available for sale included in net earnings	(263)	(527)
Total other comprehensive (loss) income, before income taxes	(1,477)	689
Income tax expense (benefit) related to other comprehensive income (loss):		
Unrealized holding (losses) gains on securities available for sale	(473)	472
Reclassification adjustment for gains on sales of securities available for sale included in net earnings	(102)	(205)
Total income tax (benefit) expense related to other comprehensive (loss) income	(575)	267
Total other comprehensive (loss) income, net of tax	(902)	422
Total comprehensive income	$ 856	2,081

See accompanying Notes to Consolidated Financial Statements.

PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows

Three Months Ended March 31, 2013 and 2012

(Dollars in thousands)

	2013 (Unaudited)	2012 (Unaudited)
Cash flows from operating activities:		
Net earnings	$ 1,758	1,659
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation, amortization and accretion	2,213	2,195
Provision for loan losses	1,053	2,049
Gain on sale of investment securities	(263)	(527)
(Gain)/Loss on sale of other real estate	(51)	57
Write-down of other real estate	39	132
Restricted stock expense	26	4
Change in:		
Mortgage loans held for sale	3,088	(1,110)
Cash surrender value of life insurance	(106)	(102)
Other assets	1,147	(245)
Other liabilities	(883)	318
Net cash provided by operating activities	8,021	4,430
Cash flows from investing activities:		
Purchases of investment securities available for sale	(22,646)	(12,437)
Proceeds from calls, maturities and paydowns of investment securities available for sale	17,781	13,638
Proceeds from sales of investment securities available for sale	5,781	20,437
Purchases of FHLB stock	-	(493)
FHLB stock redemption	384	-
Net change in loans	8,326	8,800
Purchases of premises and equipment	(1,188)	(266)
Proceeds from sales of other real estate and repossessions	2,284	893
Net cash provided by investing activities	10,722	30,572
Cash flows from financing activities:		
Net change in deposits	2,307	(19,312)
	2,810	3,879

Net change in securities sold under agreements to repurchase					
Cash dividends paid on preferred stock		(157	)	(313	)
Proceeds from FHLB borrowings		-		25,400	
Repayments of FHLB borrowings		-		(25,400	)
Cash dividends paid on common stock		(168	)	(388	)
Net cash provided (used) by financing activities		4,792		(16,134	)
Net change in cash and cash equivalent		23,535		18,868	
Cash and cash equivalents at beginning of period		48,843		29,236	
Cash and cash equivalents at end of period	$	72,378		48,104	

PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows, continued

Three Months Ended March 31, 2013 and 2012

(Dollars in thousands)

		2013 (Unaudited)	2012 (Unaudited)
Supplemental disclosures of cash flow information:			
Cash paid during the period for:			
Interest	$	1,513	2,709
Income taxes	$	101	540
Noncash investing and financing activities:			
Change in unrealized gain on investment securities available for sale, net	$	(902)	(422)
Transfers of loans to other real estate and repossessions	$	642	1,635
Financed portion of sales of other real estate	$	24	322
Accretion of Series A preferred stock	$	-	35

See accompanying Notes to Consolidated Financial Statements.

PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(1) Summary of Significant Accounting Policies

The consolidated financial statements include the financial statements of Peoples Bancorp of North Carolina, Inc. and its wholly-owned subsidiaries, Peoples Bank (the "Bank") and Community Bank Real Estate Solutions, LLC, along with the Bank's wholly-owned subsidiaries, Peoples Investment Services, Inc. and Real Estate Advisory Services, Inc. ("REAS") (collectively called the "Company"). All significant intercompany balances and transactions have been eliminated in consolidation.

The consolidated financial statements in this report (other than the Consolidated Balance Sheet at December 31, 2012) are unaudited. In the opinion of management, all adjustments (none of which were other than normal accruals) necessary for a fair presentation of the financial position and results of operations for the periods presented have been included. Management of the Company has made a number of estimates and assumptions relating to reporting of assets and liabilities and the disclosure of contingent assets and liabilities to prepare these consolidated financial statements in conformity with generally accepted accounting principles in the United States ("GAAP"). Actual results could differ from those estimates.

The Company's accounting policies are fundamental to understanding management's discussion and analysis of results of operations and financial condition. Many of the Company's accounting policies require significant judgment regarding valuation of assets and liabilities and/or significant interpretation of the specific accounting guidance. A description of the Company's significant accounting policies can be found in Note 1 of the Notes to Consolidated Financial Statements in the Company's 2012 Annual Report to Shareholders which is Appendix A to the Proxy Statement for the May 2, 2013 Annual Meeting of Shareholders.

Recently Issued Accounting Pronouncements
In January 2013, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2013-01, Balance Sheet (Topic 210): Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities. ASU No. 2013-01 provides additional guidance to clarify the intended scope of ASU No. 2011-11, Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities. ASU No. 2013-01 is effective for fiscal years beginning on or after January 1, 2013, and interim periods within those annual periods. The adoption of this guidance is not expected to have a material impact on the Company's results of operations, financial position or disclosures.

In February 2013, FASB issued ASU No. 2013-02, Comprehensive Income (Topic 220): Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income. The objective of ASU No. 2013-02 is to improve the reporting of significant reclassifications out of accumulated other comprehensive income. For public entities, ASU No. 2013-02 is effective for reporting periods beginning after December 15, 2012. The adoption of this guidance did not have a material impact on the Company's results of operations, financial position or disclosures.

Other accounting standards that have been issued or proposed by FASB or other standards-setting bodies are not expected to have a material impact on the Company's results of operations, financial position or disclosures.

Reclassification
Certain amounts in the 2012 consolidated financial statements have been reclassified to conform to the 2013 presentation.

(2) Investment Securities

Investment securities available for sale at March 31, 2013 and December 31, 2012 are as follows:

(Dollars in thousands)

	March 31, 2013			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Mortgage-backed securities	$ 134,210	1,881	347	135,744
U.S. Government sponsored enterprises	19,395	150	89	19,456
State and political subdivisions	127,046	5,749	450	132,345
Corporate bonds	3,559	23	57	3,525
Trust preferred securities	1,250	-	-	1,250
Equity securities	748	857	-	1,605
Total	$ 286,208	8,660	943	293,925

(Dollars in thousands)

	December 31, 2012			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Mortgage-backed securities	$ 146,755	1,875	606	148,024
U.S. Government sponsored enterprises	18,714	203	80	18,837
State and political subdivisions	118,591	7,171	104	125,658
Corporate bonds	2,571	19	4	2,586
Trust preferred securities	1,250	-	-	1,250
Equity securities	748	720	-	1,468
Total	$ 288,629	9,988	794	297,823

The current fair value and associated unrealized losses on investments in securities with unrealized losses at March 31, 2013 and December 31, 2012 are summarized in the tables below, with the length of time the individual securities have been in a continuous loss position.

(Dollars in thousands)

	March 31, 2013					
	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Mortgage-backed securities	$ 35,129	237	7,171	110	42,300	347
U.S. Government sponsored enterprises	6,796	89	-	-	6,796	89
State and political subdivisions	25,406	450	-	-	25,406	450
Corporate bonds	1,522	57	-	-	1,522	57
Total	$ 68,853	833	7,171	110	76,024	943

(Dollars in thousands)

December 31, 2012

		Less than 12 Months		12 Months or More		Total	
		Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Mortgage-backed securities	$	48,126	468	12,913	138	61,039	606
U.S. Government sponsored enterprises		3,402	80	-	-	3,402	80
State and political subdivisions		9,490	104	-	-	9,490	104
Corporate bonds		1,035	4	-	-	1,035	4
Total	$	62,053	656	12,913	138	74,966	794

At March 31, 2013, unrealized losses in the investment securities portfolio relating to debt securities totaled $943,000. The unrealized losses on these debt securities arose due to changing interest rates and are considered to be temporary. From the March 31, 2013 tables above, 24 out of 160 securities issued by state and political subdivisions contained unrealized losses, 23 out of 92 securities issued by U.S. Government sponsored enterprises, including mortgage-backed securities contained unrealized losses, and two out of five securities issued by corporations, contained unrealized losses. These unrealized losses are considered temporary because of acceptable investment grades on each security and the repayment sources of principal and interest on U.S. Government sponsored enterprises, including mortgage-backed securities, are government backed.

The amortized cost and estimated fair value of investment securities available for sale at March 31, 2013, by contractual maturity, are shown below. Expected maturities of mortgage-backed securities will differ from contractual maturities because borrowers have the right to call or prepay obligations with or without call or prepayment penalties.

(Dollars in thousands)

		Amortized Cost	Estimated Fair Value
Due within one year	$	4,469	4,538
Due from one to five years		22,073	22,834
Due from five to ten years		99,051	102,764
Due after ten years		25,657	26,440
Mortgage-backed securities		134,210	135,744
Equity securities		748	1,605
Total	$	286,208	293,925

Proceeds from sales of securities available for sale during the three months ended March 31, 2013 were $5.8 million and resulted in gross gains of $263,000. Proceeds from sales of securities available for sale during the three months ended March 31, 2012 were $20.4 million and resulted in gross gains of $527,000.

Securities with a fair value of approximately $74.0 million and $73.9 million at March 31, 2013 and December 31, 2012, respectively, were pledged to secure public deposits and for other purposes as required by law.

(3) Loans

Major classifications of loans at March 31, 2013 and December 31, 2012 are summarized as follows:

(Dollars in thousands)

		March 31, 2013	December 31, 2012
Real estate loans			
Construction and land development	$	72,389	73,176
Single-family residential		194,557	195,003
Single-family residential - Banco de la Gente stated income		51,410	52,019
Commercial		192,355	200,633
Multifamily and farmland		9,401	8,951
Total real estate loans		520,112	529,782
Loans not secured by real estate			

Commercial loans		65,058	64,295
Farm loans		27	11
Consumer loans		9,339	10,148
All other loans		15,429	15,738
Total loans		609,965	619,974
Less allowance for loan losses		14,412	14,423
Net loans	$	595,553	605,551

The Bank grants loans and extensions of credit primarily within the Catawba Valley region of North Carolina, which encompasses Catawba, Alexander, Iredell and Lincoln counties and also in Mecklenburg, Union and Wake counties of North Carolina. Although the Bank has a diversified loan portfolio, a substantial portion of the loan portfolio is collateralized by improved and unimproved real estate, the value of which is dependent upon the real estate market. Risk characteristics of the major components of the Bank's loan portfolio are discussed below:

- Construction and land development loans – The risk of loss is largely dependent on the initial estimate of whether the property's value at completion equals or exceeds the cost of property construction and the availability of take-out financing. During the construction phase, a number of factors can result in delays or cost overruns. If the estimate is inaccurate or if actual construction costs exceed estimates, the value of the property securing our loan may be insufficient to ensure full repayment when completed through a permanent loan, sale of the property, or by seizure of collateral. As of March 31, 2013, construction and land development loans comprised approximately 12% of the Bank's total loan portfolio.

- Single-family residential loans – Declining home sales volumes, decreased real estate values and higher than normal levels of unemployment could contribute to losses on these loans. As of March 31, 2013, single-family residential loans comprised approximately 40% of the Bank's total loan portfolio, including Banco de la Gente single-family residential stated income loans amounting to approximately 8% of the Bank's total loan portfolio.

- Commercial real estate loans – Repayment is dependent on income being generated in amounts sufficient to cover operating expenses and debt service. These loans also involve greater risk because they are generally not fully amortizing over a loan period, but rather have a balloon payment due at maturity. A borrower's ability to make a balloon payment typically will depend on being able to either refinance the loan or timely sell the underlying property. As of March 31, 2013, commercial real estate loans comprised approximately 32% of the Bank's total loan portfolio.

- Commercial loans – Repayment is generally dependent upon the successful operation of the borrower's business. In addition, the collateral securing the loans may depreciate over time, be difficult to appraise, be illiquid, or fluctuate in value based on the success of the business. As of March 31, 2013, commercial loans comprised approximately 11% of the Bank's total loan portfolio.

Loans are considered past due if the required principal and interest payments have not been received as of the date such payments were due. Loans are placed on non-accrual status when, in management's opinion, the borrower may be unable to meet payment obligations as they become due, as well as when required by regulatory provisions. Loans may be placed on non-accrual status regardless of whether or not such loans are considered past due. When interest accrual is discontinued, all unpaid accrued interest is reversed. Interest income is subsequently recognized only to the extent cash payments are received in excess of principal due. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

The following tables present an age analysis of past due loans, by loan type, as of March 31, 2013 and December 31, 2012:

March 31, 2013
(Dollars in thousands)

	Loans 30-89 Days Past Due	Loans 90 or More Days Past Due	Total Past Due Loans	Total Current Loans	Total Loans	Accruing Loans 90 or More Days Past Due

Real estate loans							
Construction and land development	$	1,095	7,189	8,284	64,105	72,389	-
Single-family residential		4,901	2,050	6,951	187,606	194,557	48
Single-family residential -							
Banco de la Gente stated income		13,425	609	14,034	37,376	51,410	-
Commercial		3,659	143	3,802	188,553	192,355	-
Multifamily and farmland		6	-	6	9,395	9,401	-
Total real estate loans		23,086	9,991	33,077	487,035	520,112	48
Loans not secured by real estate							
Commercial loans		442	399	841	64,217	65,058	-
Farm loans		-	-	-	27	27	-
Consumer loans		153	15	168	9,171	9,339	2
All other loans		-	-	-	15,429	15,429	-
Total loans	$	23,681	10,405	34,086	575,879	609,965	50

December 31, 2012
(Dollars in thousands)

	Loans 30-89 Days Past Due	Loans 90 or More Days Past Due	Total Past Due Loans	Total Current Loans	Total Loans	Accruing Loans 90 or More Days Past Due
Real estate loans						
Construction and land development	$ 1,280	6,858	8,138	65,038	73,176	-
Single-family residential	4,316	1,548	5,864	189,139	195,003	-
Single-family residential - Banco de la Gente stated income	11,077	3,659	14,736	37,283	52,019	2,378
Commercial	1,720	1,170	2,890	197,743	200,633	-
Multifamily and farmland	7	-	7	8,944	8,951	-
Total real estate loans	18,400	13,235	31,635	498,147	529,782	2,378
Loans not secured by real estate						
Commercial loans	888	66	954	63,341	64,295	23
Consumer loans	250	10	260	9,888	10,148	2
All other loans	-	-	-	15,738	15,738	-
Total loans	$ 19,538	13,311	32,849	587,125	619,974	2,403

The following table presents the Company's non-accrual loans as of March 31, 2013 and December 31, 2012:

(Dollars in thousands)

	March 31, 2013	December 31, 2012
Real estate loans		
Construction and land development	$ 9,627	9,253
Single-family residential	4,123	2,491
Single-family residential - Banco de la Gente stated income	2,367	2,232
Commercial	2,822	3,263
Total real estate loans	18,939	17,239
Loans not secured by real estate		
Commercial loans	676	344
Consumer loans	52	47
Total	$ 19,667	17,630

At each reporting period, the Bank determines which loans are impaired. Accordingly, the Bank's impaired loans are reported at their estimated fair value on a non-recurring basis. An allowance for each impaired loan that is collateral-dependent is calculated based on the fair value of its collateral. The fair value of the collateral is based on appraisals performed by REAS, a subsidiary of the Bank. REAS is staffed by certified appraisers that also perform appraisals for other companies. Factors including the assumptions and techniques utilized by the appraiser are considered by management. If the recorded investment in the impaired loan exceeds the measure of fair value of the collateral, a valuation allowance is recorded as a component of the allowance for loan losses. An allowance for each impaired loan that is non-collateral dependent is calculated based on the present value of projected cash flows. If the recorded investment in the impaired loan exceeds the present value of projected cash flows, a valuation allowance is recorded as a component of the allowance for loan losses. Impaired loans under $250,000 are not individually evaluated for impairment, with the exception of the Bank's troubled debt restructured ("TDR") loans in the residential mortgage loan portfolio, which are individually evaluated for impairment. Accruing impaired loans were $26.8 million, $30.6 million and $32.2 million at March 31, 2013, December 31, 2012 and March 31, 2012, respectively. Interest income recognized on accruing impaired loans was $293,000, $422,000 and $1.5 million for the three months ended March 31, 2013, the three months ended March 31, 2012 and the year ended December 31, 2012, respectively. No interest income is recognized on non-accrual impaired loans subsequent to their classification as non-accrual.

The following tables present the Company's impaired loans as of March 31, 2013 and December 31, 2012:

March 31, 2013
(Dollars in thousands)

		Unpaid Contractual Principal Balance	Recorded Investment With No Allowance	Recorded Investment With Allowance	Recorded Investment in Impaired Loans	Related Allowance	Average Outstanding Impaired Loans
Real estate loans							
Construction and land development	$	14,514	9,238	953	10,191	149	10,006
Single-family residential		10,422	1,031	8,599	9,630	216	8,845
Single-family residential - Banco de la Gente stated income		22,053	-	21,056	21,056	1,272	21,028
Commercial		4,895	3,971	463	4,434	7	4,840
Multifamily and farmland		189	-	189	189	1	191
Total impaired real estate loans		52,073	14,240	31,260	45,500	1,645	44,910
Loans not secured by real estate							
Commercial loans		975	-	922	922	259	931
Consumer loans		59	-	56	56	1	54
Total impaired loans	$	53,107	14,240	32,238	46,478	1,905	45,895

December 31, 2012
(Dollars in thousands)

		Unpaid Contractual Principal Balance	Recorded Investment With No Allowance	Recorded Investment With Allowance	Recorded Investment in Impaired Loans	Related Allowance	Average Outstanding Impaired Loans
Real estate loans							
Construction and land development	$	17,738	11,795	680	12,475	61	12,810
Single-family residential		9,099	766	7,799	8,565	177	7,590
Single-family residential - Banco de la Gente stated income		21,806	-	21,000	21,000	1,278	21,158
Commercial		5,830	4,569	467	5,036	6	5,433
Multifamily and farmland		193	-	193	193	1	200
Total impaired real estate loans		54,666	17,130	30,139	47,269	1,523	47,191
Loans not secured by real estate							
Commercial loans		983	347	592	939	12	1,125
Consumer loans		68	-	66	66	1	41
Total impaired loans	$	55,717	17,477	30,797	48,274	1,536	48,357

Changes in the allowance for loan losses for the three months ended March 31, 2013 and 2012 were as follows:

Three months ended March 31, 2013
(Dollars in thousands)

	Real Estate Loans									
	Construction and Land Development	Single-Family Residential	Single-Family Residential - Banco de la Gente Stated Income	Commercial	Multifamily and Farmland	Commercial	Farm	Consumer and All Other	Unallocated	
Allowance for loan losses:										
Beginning balance	$4,399	3,231	1,998	2,049	28	1,088	-	245	1,385	1
Charge-offs	(497)	(364)	(152)	-	-	(21)	-	(147)	-	(
Recoveries	1	18	-	48	-	11	-	35	-	1
Provision	882	297	130	(286)	2	131	-	99	(198)	1
Ending balance	$4,785	3,182	1,976	1,811	30	1,209	-	232	1,187	1
Ending balance: individually evaluated for impairment	$102	110	1,245	-	-	247	-	-	-	1
Ending balance: collectively evaluated for impairment	4,683	3,072	731	1,811	30	962	-	232	1,187	1
Ending balance	$4,785	3,182	1,976	1,811	30	1,209	-	232	1,187	1
Loans:										
Ending balance	$72,389	194,557	51,410	192,355	9,401	65,058	27	24,768	-	6
Ending balance: individually evaluated for impairment	$9,594	4,616	20,102	3,971	-	347	-	-	-	3
Ending balance: collectively evaluated for impairment	$62,795	189,941	31,308	188,384	9,401	64,711	27	24,768	-	5

Three months ended March 31, 2012
(Dollars in thousands)

	Real Estate Loans								
	Construction and Land Development	Single-Family Residential	Single-Family Residential - Banco de la Gente Stated Income	Commercial	Multifamily and Farmland	Commercial	Consumer and All Other	Unallocated	Total
Allowance for loan losses:									
Beginning balance	$7,182	3,253	2,104	1,731	13	1,029	255	1,037	16,604
Charge-offs	(1,851)	(105)	(173)	(71)	-	(239)	(157)	-	(2,596
Recoveries	118	2	-	374	-	5	56	-	555
Provision	1,431	(49)	249	(600)	-	209	96	713	2,049
Ending balance	$6,880	3,101	2,180	1,434	13	1,004	250	1,750	16,612
Ending balance: individually evaluated for impairment	$967	46	1,310	-	-	-	-	-	2,323
Ending balance: collectively evaluated for impairment	5,913	3,055	870	1,434	13	1,004	250	1,750	14,289
Ending balance	$6,880	3,101	2,180	1,434	13	1,004	250	1,750	16,612
Loans:									
Ending balance	$90,838	206,360	53,677	212,124	4,453	62,020	28,871	-	658,34
Ending balance: individually evaluated for impairment	$21,045	3,556	20,407	3,357	-	408	28	-	48,801
Ending balance: collectively evaluated for impairment	$69,793	202,804	33,270	208,767	4,453	61,612	28,843	-	609,54

The Company utilizes an internal risk grading matrix to assign a risk grade to each of its loans. Loans are graded on a scale of 1 to 8. These risk grades are evaluated on an ongoing basis. The Low Substandard risk grade was removed from the Company's internal risk grading matrix during the quarter ended March 31, 2013. No loans were classified Low Substandard at December 31, 2012. A description of the general characteristics of the eight risk grades is as follows:

- Risk Grade 1 – Excellent Quality: Loans are well above average quality and a minimal amount of credit risk exists. CD or cash secured loans or properly margined actively traded stock or bond secured loans would fall in this grade.

- Risk Grade 2 – High Quality: Loans are of good quality with risk levels well within the Company's range of acceptability. The organization or individual is established with a history of successful performance though somewhat susceptible to economic changes.
- Risk Grade 3 – Good Quality: Loans of average quality with risk levels within the Company's range of acceptability but higher than normal. This may be a new organization or an existing organization in a transitional phase (e.g. expansion, acquisition, market change).
- Risk Grade 4 – Management Attention: These loans have higher risk and servicing needs but still are acceptable. Evidence of marginal performance or deteriorating trends is observed. These are not problem credits presently, but may be in the future if the borrower is unable to change its present course.
- Risk Grade 5 – Watch: These loans are currently performing satisfactorily, but there has been some recent past due history on repayment and there are potential weaknesses that may, if not corrected, weaken the asset or inadequately protect the Company's position at some future date.
- Risk Grade 6 – Substandard: A Substandard loan is inadequately protected by the current sound net worth and paying capacity of the obligor or the collateral pledged (if there is any). There is a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. There is a distinct possibility that the Company will sustain some loss if the deficiencies are not corrected.
- Risk Grade 7 – Doubtful: Loans classified as Doubtful have all the weaknesses inherent in loans classified Substandard, plus 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. Doubtful is a temporary grade where a loss is expected but is presently not quantified with any degree of accuracy. Once the loss position is determined, the amount is charged off.
- Risk Grade 8 – Loss: Loans classified as Loss are considered uncollectable and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather that it is not practical or desirable to defer writing off this worthless loan even though partial recovery may be realized in the future. Loss is a temporary grade until the appropriate authority is obtained to charge the loan off.

The following tables present the credit risk profile of each loan type based on internally assigned risk grades as of March 31, 2013 and December 31, 2012.

March 31, 2013
(Dollars in thousands)

	Real Estate Loans									
	Construction and Land Development	Single-Family Residential	Single-Family Residential - Banco de la Gente Stated Income	Commercial	Multifamily and Farmland	Commercial	Farm	Consumer	All Other	Total
1- Excellent Quality	$10	20,856	-	-	-	381	-	1,205	-	22,452
2- High Quality	5,652	57,771	-	27,153	104	9,022	-	3,667	2,264	105,633
3- Good Quality	25,757	66,700	24,176	109,732	5,476	41,850	27	3,923	13,161	290,802
4- Management Attention	17,391	32,262	10,551	42,994	1,058	11,730	-	421	4	116,411
5- Watch	9,453	9,743	3,586	6,221	2,574	1,363	-	57	-	32,997
6- Substandard	14,126	7,225	13,097	6,255	189	712	-	66	-	41,670
7- Doubtful	-	-	-	-	-	-	-	-	-	-
8- Loss	-	-	-	-	-	-	-	-	-	-
Total	$72,389	194,557	51,410	192,355	9,401	65,058	27	9,339	15,429	609,965

December 31, 2012
(Dollars in thousands)

	Real Estate Loans									
	Construction and Land Development	Single-Family Residential	Single-Family Residential - Banco de la Gente Stated Income	Commercial	Multifamily and Farmland	Commercial	Farm	Consumer	All Other	Total
1- Excellent Quality	$11	24,662	-	-	-	672	-	1,239	-	26,584
2- High Quality	4,947	56,829	-	27,511	32	9,260	-	4,122	2,317	105,018
3- Good Quality	24,952	62,018	24,724	114,001	4,975	40,814	11	4,186	13,416	289,097
	18,891	35,727	11,366	47,603	3,039	11,844	-	392	5	128,867

4- Management Attention										
5- Watch	9,580	9,504	3,597	6,911	712	976	-	134	-	31,414
6- Substandard	14,795	6,263	12,332	4,607	193	729	-	70	-	38,989
7- Low Substandard	-	-	-	-	-	-	-	-	-	-
8- Doubtful	-	-	-	-	-	-	-	-	-	-
9- Loss	-	-	-	-	-	-	-	5	-	5
Total	$73,176	195,003	52,019	200,633	8,951	64,295	11	10,148	15,738	619,974

At March 31, 2013, TDR loans amounted to $21.7 million, including $253,000 in performing TDR loans. Performing TDR balances reflect current year TDR loans only, in accordance with GAAP. At December 31, 2012, TDR loans were $23.9 million, including $2.0 million in performing TDR loans. The terms of these loans have been renegotiated to provide a reduction in principal or interest as a result of the deteriorating financial position of the borrower.

The following table presents an analysis of TDR loans by loan type as of March 31, 2013.

March 31, 2013
(Dollars in thousands)

	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Real estate loans			
Construction and land development	14	$ 10,601	6,952
Single-family residential	34	2,177	2,599
Single-family residential -			
Banco de la Gente stated income	109	12,170	10,649
Commercial	6	1,567	827
Total real estate TDR loans	163	26,515	21,027
Loans not secured by real estate			
Commercial loans	15	1,257	669
Consumer loans	1	2	-
Total TDR loans	179	$ 27,774	21,696

The following table presents an analysis of first quarter 2013 loan modifications included in the March 31, 2013 TDR table above.

March 31, 2013
(Dollars in thousands)

	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Real estate loans			
Construction and land development	1	$ 117	117
Single-family residential -			
Banco de la Gente stated income	3	$332	331
Total real estate TDR loans	4	449	448
Total TDR loans	4	$449	448

The following table presents an analysis of first quarter 2012 loan modifications.

March 31, 2012
(Dollars in thousands)

	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Real estate loans			
Single-family residential -			
Banco de la Gente stated income	7	$ 732	730

Total real estate TDR loans	7		732	730
Total TDR loans	7	$	732	730

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The following table presents an analysis of TDR loans by loan type as of December 31, 2012.

December 31, 2012
(Dollars in thousands)

	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Real estate loans			
Construction and land development	11	$ 10,465	6,633
Single-family residential	33	3,014	4,084
Single-family residential -			
Banco de la Gente stated income	122	13,459	12,170
Commercial	4	1,457	682
Multifamily and farmland	-	-	-
Total real estate TDR loans	170	28,395	23,569
Loans not secured by real estate			
Commercial loans	9	511	368
Consumer loans	1	2	-
Total TDR loans	180	$ 28,908	23,937

(4) Net Earnings Per Common Share

Net earnings per common share is based on the weighted average number of common shares outstanding during the period while the effects of potential common shares outstanding during the period are included in diluted earnings per common share. The average market price during the year is used to compute equivalent shares.

The reconciliation of the amounts used in the computation of both "basic earnings per common share" and "diluted earnings per common share" for the three months ended March 31, 2013 and 2012 is as follows:

For the three months ended March 31, 2013

	Net Earnings Available to Common Shareholders (Dollars in thousands)	Common Shares	Per Share Amount
Basic earnings per common share	$ 1,601	5,613,495	$ 0.29
Effect of dilutive securities:			
Stock options	-	4,778	
Diluted earnings per common share	$ 1,601	5,618,273	$ 0.29

For the three months ended March 31, 2012

	Net Earnings Available to Common Shareholders	Common Shares	Per Share Amount

		(Dollars in thousands)			
Basic earnings per common share	$	1,311	5,544,160	$	0.24
Effect of dilutive securities:					
Stock options		-	-		
Diluted earnings per common share	$	1,311	5,544,160	$	0.24

(5) Stock-Based Compensation

The Company has an Omnibus Stock Ownership and Long Term Incentive Plan (the "1999 Plan") whereby certain stock-based rights, such as stock options, restricted stock and restricted stock units were granted to eligible directors and employees. The 1999 Plan expired on May 13, 2009 but still governs the rights and obligations of the parties for grants made thereunder.

Under the 1999 Plan, the Company granted incentive stock options to certain eligible employees in order that they may purchase Company stock at a price equal to the fair market value on the date of the grant. The options granted in 1999 vested over a five-year period. Options granted subsequent to 1999 vested over a three-year period. All options expire ten years after issuance.

In addition, under the 1999 Plan, the Company granted 3,000 restricted stock units in 2007 at a grant date fair value of $17.40 per share. The Company granted 1,750 restricted stock units at a grant date fair value of $12.80 per share during the third quarter of 2008 and 2,000 restricted stock units at a fair value of $11.37 per share during the fourth quarter of 2008. The Company recognizes compensation expense on the restricted stock units over the period of time the restrictions are in place (three years from the grant date for the grants to date under the 1999 Plan). The amount of expense recorded each period reflects the changes in the Company's stock price during the period. As of March 31, 2013, there was no unrecognized compensation cost related to the 2007 and 2008 restricted stock unit grants.

The Company also has an Omnibus Stock Ownership and Long Term Incentive Plan that was approved by shareholders on May 7, 2009 (the "2009 Plan") whereby certain stock-based rights, such as stock options, restricted stock, restricted stock units, performance units, stock appreciation rights, or book value shares, may be granted to eligible directors and employees. A total of 330,486 shares are currently reserved for possible issuance under the 2009 Plan. All rights must be granted or awarded within ten years from the May 7, 2009 effective date of the 2009 Plan.

The Company granted 29,514 restricted stock units under the 2009 Plan at a grant date fair value of $7.90 per share during the first quarter of 2012. 5,355 restricted stock units were forfeited by the executive officers of the Company as required by the agreement with the U.S. Department of the Treasury ("UST") in conjunction with the Company's participation in the Capital Purchase Program ("CPP") under the Troubled Asset Relief Program ("TARP"). In July 2012, the Company granted 5,355 restricted stock units at a grant date fair value of $8.25 per share. The Company recognizes compensation expense on the restricted stock units over the period of time the restrictions are in place (five years from the grant date for the grants to date under the 2009 Plan). The amount of expense recorded each period reflects the changes in the Company's stock price during the period. As of March 31, 2013, the total unrecognized compensation cost related to the 2012 restricted stock unit grants was $262,000.

The Company recognized compensation expense for restricted stock awards of $26,000 and $4,000 for the three months ended March 31, 2013 and 2012, respectively.

(6) Fair Value

The Company is required to disclose fair value information about financial instruments, whether or not recognized on the face of the balance sheet, for which it is practicable to estimate that value. The assumptions used in the estimation of the fair value of the Company's financial instruments are detailed below. Where quoted prices are not available, fair values are based on estimates using discounted cash flows and other valuation techniques. The use of discounted cash flows can be significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. The following disclosures should not be considered a surrogate of the liquidation value of the Company, but rather a good faith estimate of the increase or decrease in the value of financial instruments held by the Company since purchase, origination, or issuance.

The Company groups assets and liabilities at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value. These levels are:

- Level 1 – Valuation is based upon quoted prices for identical instruments traded in active markets.
- 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.
- Level 3 – Valuation is generated from model-based techniques that use at least one significant assumption not observable in the market. These unobservable assumptions reflect estimates of assumptions that market participants would use in pricing the asset or liability. Valuation techniques include use of option pricing models, discounted cash flow models and similar techniques.

Cash and Cash Equivalents
For cash, due from banks and interest-bearing deposits, the carrying amount is a reasonable estimate of fair value.

Investment Securities Available for Sale
Fair values of investment securities available for sale are determined by obtaining quoted prices on nationally recognized securities exchanges when available. If quoted prices are not available, fair value is determined using matrix pricing, which is a mathematical technique used widely in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities. Fair values for investment securities with quoted market prices are reported in the Level 1 fair value category. Fair value measurements obtained from independent pricing services are reported in the Level 2 fair value category. All other fair value measurements are reported in the Level 3 fair value category.

Other Investments
For other investments, the carrying value is a reasonable estimate of fair value.

Mortgage Loans Held for Sale
Mortgage loans held for sale are carried at lower of aggregate cost or market value. The cost of mortgage loans held for sale approximates the market value. Mortgage loans held for sale are reported in the Level 3 fair value category.

Loans
The fair value of fixed rate loans is estimated by discounting the future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings. For variable rate loans, the carrying amount is a reasonable estimate of fair value. Loans are reported in the Level 3 fair value category, as the pricing of loans is more subjective than the pricing of other financial instruments.

Cash Surrender Value of Life Insurance
For cash surrender value of life insurance, the carrying value is a reasonable estimate of fair value.

Other Real Estate
The fair value of other real estate is based upon independent market prices, appraised values of the collateral or management's estimation of the value of the collateral. Other real estate is reported in the Level 3 fair value category.

Deposits
The fair value of demand deposits, interest-bearing demand deposits and savings is the amount payable on demand at the reporting date. The fair value of certificates of deposit is estimated by discounting the future cash flows using the rates currently offered for deposits of similar remaining maturities.

Securities Sold Under Agreements to Repurchase
For securities sold under agreements to repurchase, the carrying value is a reasonable estimate of fair value.

FHLB Borrowings
The fair value of FHLB borrowings is estimated based upon discounted future cash flows using a discount rate comparable to the current market rate for such borrowings.

Junior Subordinated Debentures
Because the Company's junior subordinated debentures were issued at a floating rate, the carrying amount is a reasonable estimate of fair value.

Commitments to Extend Credit and Standby Letters of Credit

Commitments to extend credit and standby letters of credit are generally short-term and at variable interest rates. Therefore, both the carrying value and estimated fair value associated with these instruments are immaterial.

Limitations

Fair value estimates are made at a specific point in time, based on relevant market information and information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale at one time the Company's entire holdings of a particular financial instrument. Because no market exists for a significant portion of the Company's financial instruments, fair value estimates are based on many judgments. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

Fair value estimates are based on existing on and off-balance sheet financial instruments without attempting to estimate the value of anticipated future business and the value of assets and liabilities that are not considered financial instruments. Significant assets and liabilities that are not considered financial instruments include deferred income taxes and premises and equipment. In addition, the tax ramifications related to the realization of unrealized gains and losses can have a significant effect on fair value estimates and have not been considered in the estimates.

The table below presents the balance of securities available for sale, which are measured at fair value on a recurring basis by level within the fair value hierarchy as of March 31, 2013 and December 31, 2012.

(Dollars in thousands)

		March 31, 2013			
		Fair Value Measurements	Level 1 Valuation	Level 2 Valuation	Level 3 Valuation
Mortgage-backed securities	$	135,744	-	135,744	-
U.S. Government					
sponsored enterprises	$	19,456	-	19,456	-
State and political subdivisions	$	132,345	-	132,345	-
Corporate bonds	$	3,525	-	3,525	-
Trust preferred securities	$	1,250	-	-	1,250
Equity securities	$	1,605	1,605	-	-

(Dollars in thousands)

		December 31, 2012			
		Fair Value Measurements	Level 1 Valuation	Level 2 Valuation	Level 3 Valuation
Mortgage-backed securities	$	148,024	-	148,024	-
U.S. Government					
sponsored enterprises	$	18,837	-	18,837	-
State and political subdivisions	$	125,658	-	125,658	-
Corporate bonds	$	2,586	-	2,586	-
Trust preferred securities	$	1,250	-	-	1,250
Equity securities	$	1,468	1,468	-	-

Fair values of investment securities available for sale are determined by obtaining quoted prices on nationally recognized securities exchanges when available. If quoted prices are not available, fair value is determined using matrix pricing, which is a mathematical technique used widely in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities.

The following is an analysis of fair value measurements of investment securities available for sale using Level 3, significant unobservable inputs, for the three months ended March 31, 2013.

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(Dollars in thousands)

		Investment Securities Available for Sale Level 3 Valuation
Balance, beginning of period	$	1,250
Change in book value		-
Change in gain/(loss) realized and unrealized		-
Purchases/(sales)		-
Transfers in and/or (out) of Level 3		-
Balance, end of period	$	1,250
Change in unrealized gain/(loss) for assets still held in Level 3	$	-

The fair value measurements for impaired loans and other real estate on a non-recurring basis at March 31, 2013 and December 31, 2012 are presented below. The fair value measurement process uses certified appraisals and other market-based information; however, in many cases, it also requires significant input based on management's knowledge of and judgment about current market conditions, specific issues relating to the collateral, and other matters. As a result, all fair value measurements for impaired loans and other real estate are considered Level 3.

(Dollars in thousands)

		Fair Value Measurements March 31, 2013	Level 1 Valuation	Level 2 Valuation	Level 3 Valuation	Total Gains/(Losses) for the Three Months Ended March 31, 2013
Impaired loans	$	44,573	-	-	44,573	(1,013)
Other real estate	$	4,588	-	-	4,588	12

(Dollars in thousands)

		Fair Value Measurements December 31, 2012	Level 1 Valuation	Level 2 Valuation	Level 3 Valuation	Total Gains/(Losses) for the Year Ended December 31, 2012
Impaired loans	$	46,738	-	-	46,738	(6,875)
Other real estate	$	6,254	-	-	6,254	(1,136)

The carrying amount and estimated fair value of financial instruments at March 31, 2013 and December 31, 2012 are as follows:

(Dollars in thousands)

			Fair Value Measurements at March 31, 2013			
		Carrying Amount	Level 1	Level 2	Level 3	Total
Assets:						
Cash and cash equivalents	$	72,378	72,378	-	-	72,378
Investment securities available for sale		293,925	1,605	291,070	1,250	293,925
Other investments		5,215	-	-	5,215	5,215
Mortgage loans held for sale		3,834	-	-	3,834	3,834

Loans, net		595,553	-	-	589,155	589,155
Cash surrender value of life insurance		13,379	-	13,379	-	13,379
Liabilities:						
Deposits	$	783,832	-	782,888	-	782,888
Securities sold under agreements						
to repurchase		37,388	-	37,388	-	37,388
FHLB borrowings		70,000	-	76,529	-	76,529
Junior subordinated debentures		20,619	-	20,619	-	20,619

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(Dollars in thousands)

		Fair Value Measurements at December 31, 2012			
	Carrying Amount	Level 1	Level 2	Level 3	Total
Assets:					
Cash and cash equivalents	$ 48,843	48,843	-	-	48,843
Investment securities available for sale	297,823	1,468	295,105	1,250	297,823
Other investments	5,599	-	-	5,599	5,599
Mortgage loans held for sale	6,922	-	-	6,922	6,922
Loans, net	605,551	-	-	599,996	599,996
Cash surrender value of life insurance	13,273	-	13,273	-	13,273
Liabilities:					
Deposits	$ 781,525	-	780,662	-	780,662
Securities sold under agreements to repurchase	34,578	-	34,578	-	34,578
FHLB borrowings	70,000	-	76,375	-	76,375
Junior subordinated debentures	20,619	-	20,619	-	20,619

(7) Derivative Instruments and Hedging Activities

Accounting Policy for Derivative Instruments and Hedging Activities

The disclosure requirements for derivatives and hedging activities have the intent to provide users of financial statements with an enhanced understanding of: (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for and (c) how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. The disclosure requirements include qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about the fair value of and gains and losses on derivative instruments, and disclosures about credit-risk-related contingent features in derivative instruments.

The Company records all derivatives on the balance sheet at fair value. The accounting for changes in the fair value of derivatives depends on the intended use of the derivative, whether the Company has elected to designate a derivative in a hedging relationship and apply hedge accounting and whether the hedging relationship has satisfied the criteria necessary to apply hedge accounting. Derivatives designated and qualifying as a hedge of the exposure to changes in the fair value of an asset, liability, or firm commitment attributable to a particular risk, such as interest rate risk, are considered fair value hedges. Derivatives designated and qualifying as a hedge of the exposure to variability in expected future cash flows, or other types of forecasted transactions, are considered cash flow hedges. Hedge accounting generally provides for the matching of the timing of gain or loss recognition on the hedging instrument with the recognition of the changes in the fair value of the hedged asset or liability that are attributable to the hedged risk in a fair value hedge or the earnings effect of the hedged forecasted transactions in a cash flow hedge. The Company may enter into derivative contracts that are intended to economically hedge certain of its risks, even though hedge accounting does not apply or the Company elects not to apply hedge accounting.

Risk Management Objective of Using Derivatives

The Company has an overall interest rate risk management strategy that incorporates the use of derivative instruments to minimize significant unplanned fluctuations in earnings that are caused by interest rate volatility. By using derivative instruments, the Company is exposed to credit and market risk. If the counterparty fails to perform, credit risk is equal to the extent of the fair value gain in the derivative. The Company minimizes the credit risk in derivative instruments by entering into transactions with high-quality counterparties that are reviewed periodically by the Company. The Company did not have any interest rate derivatives outstanding as of March 31, 2013 and December 31, 2012.

Fair Values of Derivative Instruments on the Balance Sheet

The Company did not have any interest rate derivatives outstanding as of March 31, 2013 and December 31, 2012.

Cash Flow Hedges of Interest Rate Risk

The Company's objectives in using interest rate derivatives are to add stability to interest income and expense and to manage its exposure to interest rate movements. To accomplish this objective, the Company primarily uses interest rate swaps and floors as part of its interest rate risk management strategy. For hedges of the Company's variable-rate loan assets, interest rate swaps designated as cash flow hedges involve the receipt of fixed-rate amounts from a counterparty in exchange for the Company making variable-rate payments over the life of the agreements without exchange of the underlying notional amount. For hedges of the Company's variable-rate loan assets, the interest rate floors designated as a cash flow hedge involves the receipt of variable-rate amounts from a counterparty if interest rates fall below the strike rate on the contract in exchange for an up front premium. The Company had an interest rate swap contract that expired in June 2011. The Company did not have any interest rate derivatives outstanding as of March 31, 2013 and December 31, 2012.

The effective portion of changes in the fair value of derivatives designated and that qualify as cash flow hedges is recorded in "Accumulated Other Comprehensive Income" and is subsequently reclassified into earnings in the period that the hedged forecasted transaction affects earnings. The ineffective portion of the change in fair value of the derivatives is recognized directly in earnings.

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

The following is a discussion of our financial position and results of operations and should be read in conjunction with the information set forth under Item 1A Risk Factors and the Company's Consolidated Financial Statements and Notes thereto on pages A-28 through A-64 of the Company's 2012 Annual Report to Shareholders which is Appendix A to the Proxy Statement for the May 2, 2013 Annual Meeting of Shareholders.

Introduction

Management's discussion and analysis of earnings and related data are presented to assist in understanding the consolidated financial condition and results of operations of the Company. The Company is the parent company of the Bank and a registered bank holding company operating under the supervision of the Board of Governors of the Federal Reserve System (the "Federal Reserve"). The Bank is a North Carolina-chartered bank, with offices in Catawba, Lincoln, Alexander, Mecklenburg, Iredell, Union and Wake counties, operating under the banking laws of North Carolina and the rules and regulations of the Federal Deposit Insurance Corporation (the "FDIC").

Overview

Our business consists principally of attracting deposits from the general public and investing these funds in commercial loans, real estate mortgage loans, real estate construction loans and consumer loans. Our profitability depends primarily on our net interest income, which is the difference between the income we receive on our loan and investment securities portfolios and our cost of funds, which consists of interest paid on deposits and borrowed funds. Net interest income also is affected by the relative amounts of our interest-earning assets and interest-bearing liabilities. When interest-earning assets approximate or exceed interest-bearing liabilities, a positive interest rate spread will generate net interest income. Our profitability is also affected by the level of other income and operating expenses. Other income consists primarily of miscellaneous fees related to our loans and deposits, mortgage banking income and commissions from sales of annuities and mutual funds. Operating expenses consist of compensation and benefits, occupancy related expenses, federal deposit and other insurance premiums, data processing, advertising and other expenses.

Our operations are influenced significantly by local economic conditions and by policies of financial institution regulatory authorities. The earnings on our assets are influenced by the effects of, and changes in, trade, monetary and fiscal policies and laws, including interest rate policies of the Federal Reserve, inflation, interest rates, market and monetary fluctuations. Lending activities are affected by the demand for commercial and other types of loans, which in turn is affected by the interest rates at which such financing may be offered. Our cost of funds is influenced by interest rates on competing investments and by rates offered on similar investments by competing financial institutions in our market area, as well as general market interest rates. These factors can cause fluctuations in our net interest income and other income. In addition, local economic conditions can impact the credit risk of our loan portfolio, in that (1) local employers may be required to eliminate employment positions of individual borrowers, and (2) small businesses and commercial borrowers may experience a downturn in their operating performance and become unable to make timely payments on their loans. Management evaluates these factors in estimating its allowance for loan losses and changes in these economic factors could result in increases or decreases to the provision for loan losses.

Economic conditions in 2013, while demonstrating some sign of improvement, continue to have a negative impact on our financial condition and results of operations. Unfavorable economic indicators, such as high unemployment, depressed real estate prices and higher than normal levels of loan defaults demonstrate the difficult business conditions that are affecting the general economy and therefore our operating results. The unemployment rates in our primary market area continue to be higher than state and national averages.

On July 21, 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") into law. This legislation made extensive changes to the laws regulating financial products and services as well as firms and companies offering financial products and services. The Dodd-Frank Act also altered certain corporate governance matters affecting public companies. The legislation requires substantial rulemaking and mandates numerous additional studies, the results of which could impact future legislative and regulatory action. We continue to evaluate this legislation including its related rules and regulations, and we continue to assess the extent to which it will impact our current and future operations.

While we are unable to determine all ramifications of the Dodd-Frank Act at this time, we expect that many of the requirements called for in the Dodd-Frank Act will be implemented over time, and most will be subject to implementing regulations over the course of several years. Given the uncertainty associated with the manner in which the provisions of the Dodd-Frank Act will be implemented by the various regulatory agencies, the full extent of the impact of such requirements will have on financial institutions' operations is unclear. The changes resulting from the Dodd-Frank Act may impact the profitability of our business activities, require changes to certain of our business practices, impose upon us more stringent capital, liquidity and leverage ratio requirements or otherwise adversely affect our business. These changes may also require us to invest significant management attention and resources to evaluate and make necessary changes in order to comply with new statutory and regulatory requirements.

Although we are unable to control the external factors that influence our business, by maintaining high levels of balance sheet liquidity, managing our interest rate exposures and by actively monitoring asset quality, we seek to minimize the potentially adverse risks of unforeseen and unfavorable economic trends.

Our business emphasis has been to operate as a well-capitalized, profitable and independent community-oriented financial institution dedicated to providing quality customer service. We are committed to meeting the financial needs of the communities in which we operate. We believe that we can be more effective in servicing our customers than many of our non-local competitors because of our ability to quickly and effectively provide senior management responses to customer needs and inquiries. While we continue to focus our resources in and around our current footprint, we do consider other avenues of growth that would add shareholder value. We were an unsuccessful bidder in a recent FDIC assisted transaction and we will consider other opportunities as they become available.

The Federal Reserve has maintained the Federal Funds Rate at 0.25% since December 2008. This historically low rate has had a negative impact on earnings and will continue to have a negative impact on our net interest income in future periods. The negative impact of low interest rates has been partially offset by earnings realized on interest rate contracts utilized by the Bank. Additional information regarding the Bank's interest rate contacts is provided below in the section entitled "Asset Liability and Interest Rate Risk Management."

On December 23, 2008, the Company entered into a Securities Purchase Agreement ("Purchase Agreement") with the UST pursuant to the CPP under the TARP. Under the Purchase Agreement, the Company agreed to issue and sell 25,054 shares of Series A preferred stock and a Warrant to purchase 357,234 shares of the Company's common stock. Proceeds from this issuance of Series A preferred shares were allocated between preferred stock and the Warrant based on their relative fair values at the time of the sale. Of the $25.1 million in proceeds, $24.4 million was allocated to the Series A preferred stock and $704,000 was allocated to the Warrant. The discount recorded on the Series A preferred stock that resulted from allocating a portion of the proceeds to the Warrant was being accreted directly to retained earnings over a five-year period applying a level yield. As of March 31, 2013, the Company had accreted a total of $478,000 of the discount related to the Series A preferred stock.

The Series A preferred stock qualifies as Tier 1 capital and will pay cumulative dividends at a rate of 5% per annum for the first five years and 9% per annum thereafter. The Series A preferred stock may be redeemed at the stated amount of $1,000 per share plus any accrued and unpaid dividends. Under the terms of the original Purchase Agreement, the Company could not redeem the Series A preferred shares until December 23, 2011 unless the total amount of the issuance, $25.1 million, was replaced with the same amount of other forms of capital that would qualify as Tier 1 capital. However, with the enactment of the American Recovery and Reinvestment Act of 2009 ("ARRA"), the Company can now redeem the Series A preferred shares at any time, if approved by the Company's primary regulator. The Series A preferred stock is non-voting except for class voting rights on matters that would adversely affect the rights of the holders of the Series A preferred stock.

The UST sold all of its Series A preferred stock in a public auction in June 2012, and, as a result, the Company is no longer subject to the executive compensation and corporate governance standards imposed by TARP. The Company purchased 12,530 shares of the 25,054 outstanding shares of Series A preferred stock from the UST. The shares were purchased for $933.36 per share, for a total purchase price of $11,778,576, including $83,575 accrued and unpaid dividends on the Series A preferred stock. The Company retired the 12,530 shares purchased. The $834,999 difference between the $12,530,000 face value of the Series A preferred stock retired and the $11,695,001 purchase price of the Series A preferred stock retired was credited to retained earnings effective June 30, 2012. Remaining Series A preferred shares are redeemable at any time at par. The Company expects to be able to repurchase the shares from future earnings, however, there are no immediate plans to repurchase these shares.

During the third quarter of 2012, the Company completed its repurchase of the Warrant to purchase 357,234 shares of the Company's common stock. The Company repurchased the Warrant for a total price of $425,000. The exercise price of the Warrant was $10.52 per common share and was exercisable at anytime on or before December 18, 2018. The Company is no longer accreting the discount associated with the Warrant.

Summary of Significant Accounting Policies

The Company’s accounting policies are fundamental to understanding management’s discussion and analysis of results of operations and financial condition. Many of the Company’s accounting policies require significant judgment regarding valuation of assets and liabilities and/or significant interpretation of specific accounting guidance. A more complete description of the Company’s significant accounting policies can be found in Note 1 of the Notes to Consolidated Financial Statements in the Company’s 2012 Annual Report to Shareholders which is Appendix A to the Proxy Statement for the May 2, 2013 Annual Meeting of Shareholders.

Many of the Company's assets and liabilities are recorded using various techniques that require significant judgment as to recoverability. The collectibility of loans is reflected through the Company's estimate of the allowance for loan losses. The Company performs periodic and systematic detailed reviews of its lending portfolio to assess overall collectibility. In addition, certain assets and liabilities are reflected at their estimated fair value in the consolidated financial statements. Such amounts are based on either quoted market prices or estimated values derived from dealer quotes used by the Company, market comparisons or internally generated modeling techniques. The Company's internal models generally involve present value of cash flow techniques. The various techniques are discussed in greater detail elsewhere in management's discussion and analysis and the Notes to the Consolidated Financial Statements.

There are other complex accounting standards that require the Company to employ significant judgment in interpreting and applying certain of the principles prescribed by those standards. These judgments include, but are not limited to, the determination of whether a financial instrument or other contract meets the definition of a derivative in accordance with GAAP.

The disclosure requirements for derivatives and hedging activities have the intent to provide users of financial statements with an enhanced understanding of: (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for and (c) how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. The disclosure requirements include qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about the fair value of and gains and losses on derivative instruments, and disclosures about credit-risk-related contingent features in derivative instruments.

The Company records all derivatives on the balance sheet at fair value. The accounting for changes in the fair value of derivatives depends on the intended use of the derivative, whether the Company has elected to designate a derivative in a hedging relationship and apply hedge accounting and whether the hedging relationship has satisfied the criteria necessary to apply hedge accounting. Derivatives designated and qualifying as a hedge of the exposure to changes in the fair value of an asset, liability, or firm commitment attributable to a particular risk, such as interest rate risk, are considered fair value hedges. Derivatives designated and qualifying as a hedge of the exposure to variability in expected future cash flows, or other types of forecasted transactions, are considered cash flow hedges. Hedge accounting generally provides for the matching of the timing of gain or loss recognition on the hedging instrument with the recognition of the changes in the fair value of the hedged asset or liability that are attributable to the hedged risk in a fair value hedge or the earnings effect of the hedged forecasted transactions in a cash flow hedge. The Company may enter into derivative contracts that are intended to economically hedge certain of its risks, even though hedge accounting does not apply or the Company elects not to apply hedge accounting.

The Company has an overall interest rate risk management strategy that incorporates the use of derivative instruments to minimize significant unplanned fluctuations in earnings that are caused by interest rate volatility. By using derivative instruments, the Company is exposed to credit and market risk. If the counterparty fails to perform, credit risk is equal to the extent of the fair-value gain in the derivative. The Company minimizes the credit risk in derivative instruments by entering into transactions with high-quality counterparties that are reviewed periodically by the Company. The Company had an interest rate swap contract that expired in June 2011. The Company did not have any interest rate derivatives outstanding as of March 31, 2013.

The Company's objectives in using interest rate derivatives are to add stability to interest income and expense and to manage its exposure to interest rate movements. To accomplish this objective, the Company primarily uses interest rate swaps and floors as part of its interest rate risk management strategy. For hedges of the Company's variable-rate loan assets, interest rate swaps designated as cash flow hedges involve the receipt of fixed-rate amounts from a counterparty in exchange for the Company making variable-rate payments over the life of the agreements without exchange of the underlying notional amount. For hedges of the Company's variable-rate loan assets, the interest rate floor designated as a cash flow hedge involves the receipt of variable-rate amounts from a counterparty if interest rates fall below the strike rate on the contract in exchange for an up front premium.

The effective portion of changes in the fair value of derivatives designated and that qualify as cash flow hedges is recorded in "Accumulated Other Comprehensive Income" and is subsequently reclassified into earnings in the period that the hedged forecasted transaction affects earnings. The ineffective portion of the change in fair value of the derivatives is recognized directly in earnings.

GAAP establishes a framework for measuring fair value and expands disclosures about fair value measurements. There is a three-level fair value hierarchy for fair value measurements. Level 1 inputs are quoted prices in active markets for identical assets or liabilities that a company has the ability to access at the measurement date. Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. Level 3 inputs are unobservable inputs for the asset or liability. The table below presents the balance of securities available for sale, which are measured at fair value on a recurring basis by level within the fair value hierarchy as of March 31, 2013 and December 31, 2012.

(Dollars in thousands)

	March 31, 2013			
	Fair Value Measurements	Level 1 Valuation	Level 2 Valuation	Level 3 Valuation
Mortgage-backed securities	$ 135,744	-	135,744	-
U.S. Government sponsored enterprises	$ 19,456	-	19,456	-
State and political subdivisions	$ 132,345	-	132,345	-
Corporate bonds	$ 3,525	-	3,525	-
Trust preferred securities	$ 1,250	-	-	1,250
Equity securities	$ 1,605	1,605	-	-

(Dollars in thousands)

	December 31, 2012			
	Fair Value Measurements	Level 1 Valuation	Level 2 Valuation	Level 3 Valuation
Mortgage-backed securities	$ 148,024	-	148,024	-
U.S. Government sponsored enterprises	$ 18,837	-	18,837	-
State and political subdivisions	$ 125,658	-	125,658	-
Corporate bonds	$ 2,586	-	2,586	-
Trust preferred securities	$ 1,250	-	-	1,250
Equity securities	$ 1,468	1,468	-	-

Fair values of investment securities available for sale are determined by obtaining quoted prices on nationally recognized securities exchanges when available. If quoted prices are not available, fair value is determined using matrix pricing, which is a mathematical technique used widely in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities.

The following is an analysis of fair value measurements of investment securities available for sale using Level 3, significant unobservable inputs, for the three months ended March 31, 2013:

(Dollars in thousands)

	Investment Securities Available for Sale Level 3 Valuation
Balance, beginning of period	$ 1,250
Change in book value	-
Change in gain/(loss) realized and unrealized	-
Purchases/(sales)	-

Transfers in and/or (out) of Level 3		-
Balance, end of period	$	1,250
Change in unrealized gain/(loss) for assets still held in Level 3	$	-

The Bank's March 31, 2013 and December 31, 2012 fair value measurements for impaired loans and other real estate on a non-recurring basis are presented below. The fair value measurement process uses certified appraisals and other market-based information; however, in many cases, it also requires significant input based on management's knowledge of and judgment about current market conditions, specific issues relating to the collateral, and other matters. As a result, all fair value measurements for impaired loans and other real estate are considered Level 3.

(Dollars in thousands)

		Fair Value Measurements March 31, 2013	Level 1 Valuation	Level 2 Valuation	Level 3 Valuation	Total Gains/(Losses) for the Three Months Ended March 31, 2013
Impaired loans	$	44,573	-	-	44,573	(1,013)
Other real estate	$	4,588	-	-	4,588	12

(Dollars in thousands)

		Fair Value Measurements December 31, 2012	Level 1 Valuation	Level 2 Valuation	Level 3 Valuation	Total Gains/(Losses) for the Year Ended December 31, 2012
Impaired loans	$	46,738	-	-	46,738	(6,875)
Other real estate	$	6,254	-	-	6,254	(1,136)

At each reporting period, the Bank determines which loans are impaired. Accordingly, the Bank's impaired loans are reported at their estimated fair value on a non-recurring basis. An allowance for each impaired loan that is collateral-dependent is calculated based on the fair value of its collateral. The fair value of the collateral is based on appraisals performed by REAS, a subsidiary of the Bank. REAS is staffed by certified appraisers that also perform appraisals for other companies. Factors including the assumptions and techniques utilized by the appraiser are considered by management. If the recorded investment in the impaired loan exceeds the measure of fair value of the collateral, a valuation allowance is recorded as a component of the allowance for loan losses. An allowance for each impaired loan that is non-collateral dependent is calculated based on the present value of projected cash flows. If the recorded investment in the impaired loan exceeds the present value of projected cash flows, a valuation allowance is recorded as a component of the allowance for loan losses. Impaired loans under $250,000 are not individually evaluated for impairment, with the exception of the Bank's TDR loans in the residential mortgage loan portfolio, which are individually evaluated for impairment. Accruing impaired loans were $26.8 million, $30.6 million and $32.2 million at March 31, 2013, December 31, 2012 and March 31, 2012, respectively. Interest income recognized on accruing impaired loans was $293,000, $422,000 and $1.5 million for the three months ended March 31, 2013, the three months ended March 31, 2012 and the year ended December 31, 2012, respectively. No interest income is recognized on non-accrual impaired loans subsequent to their classification as non-accrual.

Results of Operations

Summary. Net earnings for the first quarter of 2013 were $1.8 million, or $0.31 basic and diluted net earnings per share before adjustment for preferred stock dividends, as compared to $1.7 million, or $0.30 basic and diluted net earnings per share before adjustment for preferred stock dividends and accretion for the same period one year ago. After adjusting for dividends and accretion on preferred stock, net earnings available to common shareholders for the three months ended March 31, 2013 were $1.6 million, or $0.29 basic and diluted net earnings per common share as compared to $1.3 million, or $0.24 basic and diluted net earnings per common share for the same period one year ago. The increase in first quarter earnings is attributable to a decrease in the provision for loan losses, which was partially offset by a decrease in net interest income and an increase in non-interest expense.

The annualized return on average assets was 0.71% for the three months ended March 31, 2013 compared to 0.63% for the same period one year ago, and annualized return on average shareholders' equity was 7.17% for the three months ended March 31, 2013 compared to 6.34% for the same period one year ago.

Net Interest Income. Net interest income, the major component of the Company's net earnings, was $7.6 million for the three months ended March 31, 2013 compared to $8.1 million for the same period one year ago. This decrease was primarily due to a decrease in interest income resulting from decreases in loans and investment securities and a decrease in the yield on earning assets, which were partially offset by a decrease in interest expense due to a reduction in the cost of funds and a reduction in interest-bearing liabilities.

Interest income decreased $1.3 million or 12% for the three months ended March 31, 2013 compared to the same period one year ago. The decrease was due to a reduction in average loans and investment securities and a decrease in the yield on earning assets. The average yield on earning assets for the quarters ended March 31, 2013 and 2012 was 4.15% and 4.34%, respectively. During the quarter ended March 31, 2013, average loans decreased $50.5 million to $621.1 million from $671.6 million for the three months ended March 31, 2012. During the quarter ended March 31, 2013, average investment securities available for sale decreased $27.0 million to $286.5 million from $313.5 million for the three months ended March 31, 2012. This decrease reflects maturities, calls and sales of available for sale investments exceeding purchases of available for sale investments.

Interest expense decreased $755,000 or 34% for the three months ended March 31, 2013 compared with the same period one year ago due to lower cost of funds and a reduction in certificates of deposit. The average rate paid on interest-bearing checking and savings accounts was 0.24% for the three months ended March 31, 2013 as compared to 0.39% for the same period one year ago. The average rate paid on certificates of deposits was 0.78% for the three months ended March 31, 2013 compared to 1.30% for the same period one year ago. During the quarter ended March 31, 2013, average certificates of deposit decreased $76.4 million to $242.4 million from $318.8 million for the three months ended March 31, 2012.

The following table sets forth for each category of interest-earning assets and interest-bearing liabilities, the average amounts outstanding, the interest incurred on such amounts and the average rate earned or incurred for the three months ended March 31, 2013 and 2012. The table also sets forth the average rate earned on total interest-earning assets, the average rate paid on total interest-bearing liabilities, and the net yield on average total interest-earning assets for the same periods. Yield information does not give effect to changes in fair value that are reflected as a component of shareholders' equity. Yields and interest income on tax-exempt investments have been adjusted to tax equivalent basis using an effective tax rate of 38.55% for securities that are both federal and state tax exempt, an effective tax rate of 31.65% for federal tax exempt securities and an effective tax rate of 6.90% for state tax exempt securities. Non-accrual loans and the interest income that was recorded on these loans, if any, are included in the yield calculations for loans in all periods reported.

		Three months ended March 31, 2013			Three months ended March 31, 2012		
(Dollars in thousands)		Average Balance	Interest	Yield / Rate	Average Balance	Interest	Yield / Rate
Interest-earning assets:							
Interest and fees on loans	$	621,077	7,640	4.99%	671,580	8,425	5.05%
Investments - taxable		149,063	341	0.93%	218,826	1,082	1.99%
Investments - nontaxable*		143,639	1,596	4.51%	101,233	1,249	4.96%
Other		23,041	12	0.21%	6,208	3	0.19%
Total interest-earning assets		936,820	9,589	4.15%	997,847	10,759	4.34%
Cash and due from banks		25,754			22,831		
Other assets		56,391			55,877		
Allowance for loan losses		(14,708)			(17,144)		
Total assets	$	1,004,257			1,059,411		
Interest-bearing liabilities:							
NOW, MMDA & savings deposits	$	368,441	218	0.24%	351,219	344	0.39%
Time deposits		242,414	467	0.78%	318,757	1,032	1.30%
FHLB borrowings		70,000	661	3.83%	71,406	690	3.89%
Trust preferred securities		20,619	100	1.98%	20,619	113	2.20%
Other		36,748	17	0.19%	44,296	39	0.36%

Total interest-bearing liabilities		738,222	1,463	0.80%	806,297	2,218	1.11%
Demand deposits		162,790			144,282		
Other liabilities		4,507			4,284		
Shareholders' equity		99,381			105,202		
Total liabilities and shareholder's equity	$	1,004,900			1,060,065		
Net interest spread			$ 8,126	3.35%		8,541	3.23%
Net yield on interest-earning assets				3.52%			3.44%
Taxable equivalent adjustment							
Investment securities			$ 486			397	
Net interest income			$ 7,640			8,144	

*Includes U.S. Government agency securities that are non-taxable for state income tax purposes of $19.2 million in 2013 and $6.3 million in 2012. An effective tax rate of 6.90% was used to calculate the tax equivalent yield on these securities.

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Changes in interest income and interest expense can result from variances in both volume and rates. The following table presents the impact on the Company's tax equivalent net interest income resulting from changes in average balances and average rates for the periods indicated. The changes in interest due to both volume and rate have been allocated to volume and rate changes in proportion to the relationship of the absolute dollar amounts of the changes in each.

	Three months ended March 31, 2013 compared to three months ended March 31, 2012			Three months ended March 31, 2012 compared to three months ended March 31, 2011		
(Dollars in thousands)	Changes in average volume	Changes in average rates	Total Increase (Decrease)	Changes in average volume	Changes in average rates	Total Increase (Decrease)
Interest income:						
Loans: Net of unearned income	$(627)	(158)	(785)	(647)	(541)	(1,188)
Investments - taxable	(252)	(489)	(741)	435	(234)	201
Investments - nontaxable	497	(150)	347	(390)	146	(244)
Other	9	0	9	(4)	0	(4)
Total interest income	(373)	(797)	(1,170)	(606)	(629)	(1,235)
Interest expense:						
NOW, MMDA & savings deposits	14	(140)	(126)	27	(400)	(373)
Time deposits	(197)	(368)	(565)	(223)	(149)	(372)
FHLB borrowings	(13)	(16)	(29)	13	(67)	(54)
Trust preferred securities	-	(13)	(13)	-	13	13
Other	(5)	(17)	(22)	11	(51)	(40)
Total interest expense	(201)	(554)	(755)	(172)	(654)	(826)
Net interest income	$(172)	(243)	(415)	(434)	25	(409)

Provision for Loan Losses. For the three months ended March 31, 2013, a contribution of $1.1 million was made to the provision for loan losses compared to a $2.0 million contribution to the provision for loan losses for the three months ended March 31, 2012. The decrease in the provision for loan losses is primarily attributable to a $4.3 million reduction in non-accrual loans from March 31, 2012 to March 31, 2013.

Non-Interest Income. Total non-interest income was $3.4 million for the three months ended March 31, 2013 and 2012. Decreases in service charge income and gains on sale of securities were offset by increases in mortgage banking income, miscellaneous non-interest income, and $12,000 net gains on sales and write-downs of other real estate for the three months ended March 31, 2013 compared to $189,000 net losses on sales and write-downs of other real estate for the same period one year ago.

Non-Interest Expense. Total non-interest expense was $7.7 million for the three months ended March 31, 2013, as compared to $7.3 million for the same period one year ago. This increase is attributable to a $349,000 increase in salaries and employee benefits expense, which was primarily due to 2013 salary increases, increases in commissions paid and bonuses accrued in the first quarter of 2013, and a $107,000 increase in non-interest expenses other than salary, employee benefits and occupancy expenses for the three months ended March 31, 2013, as compared to the same period one year ago.

Income Taxes. The Company reported income tax expense of $518,000 and $545,000 for the three months ended March 31, 2013 and 2012, respectively. This represented an effective tax rate of 23% and 25% for the respective periods.

Analysis of Financial Condition

Investment Securities. Available for sale securities were $293.9 million at March 31, 2013 compared to $297.8 million at December 31, 2012. Average investment securities available for sale for the three months ended March 31, 2013 were $286.5 million compared to $289.0 million for the year ended December 31, 2012.

Loans. At March 31, 2013, loans were $610.0 million compared to $620.0 million at December 31, 2012, a decrease of $10.0 million. This decrease reflects a decline in loan originations combined with continuing payments on existing loans. Loans originated or renewed during the three months ended March 31, 2013, amounting to approximately $26.2 million, were offset by paydowns and payoffs of existing loans. Average loans represented 66% and 67% of average earning assets for the three months ended March 31, 2013 and the year ended December 31, 2012, respectively. The Company had $3.8 million and $6.9 million in mortgage loans held for sale as of March 31, 2013 and December 31, 2012, respectively.

Although the Company has a diversified loan portfolio, a substantial portion of the loan portfolio is collateralized by real estate, which is dependent upon the real estate market. Real estate mortgage loans include both commercial and residential mortgage loans. At March 31, 2013, the Company had $107.5 million in residential mortgage loans, $85.8 million in home equity loans and $254.6 million in commercial mortgage loans, which include $201.8 million secured by commercial property and $52.8 million secured by residential property. Residential mortgage loans include $55.7 million made to customers in the Company's traditional banking offices and $51.8 million in mortgage loans originated in the Company's Latino banking offices. All residential mortgage loans are originated as fully amortizing loans, with no negative amortization.

At March 31, 2013, the Company had $72.4 million in construction and land development loans. The following table presents a breakout of these loans.

(Dollars in thousands)

	Number of Loans	Balance Outstanding	Non-accrual Balance
Land acquisition and development - commercial purposes	69	$ 16,507	$ 1,671
Land acquisition and development - residential purposes	304	46,444	7,415
1 to 4 family residential construction	24	4,193	541
Commercial construction	5	5,245	-
Total construction and land development	402	$ 72,389	$ 9,627

At March 31, 2013, TDR loans amounted to $21.7 million, including $253,000 in performing TDR loans. Performing TDR balances reflect current year TDR loans only, in accordance with GAAP. At December 31, 2012, TDR loans were $23.9 million, including $2.0 million in performing TDR loans. The terms of these loans have been renegotiated to provide a reduction in principal or interest as a result of the deteriorating financial position of the borrower.

Allowance for Loan Losses. The allowance for loan losses reflects management's assessment and estimate of the risks associated with extending credit and its evaluation of the quality of the loan portfolio. The Bank periodically analyzes the loan portfolio in an effort to review asset quality and to establish an allowance for loan losses that management believes will be adequate in light of anticipated risks and loan losses. In assessing the adequacy of the allowance, size, quality and risk of loans in the portfolio are reviewed. Other factors considered are:

- the Bank's loan loss experience;
- the amount of past due and non-performing loans;
- specific known risks;
- the status and amount of other past due and non-performing assets;
- underlying estimated values of collateral securing loans;
- current and anticipated economic conditions; and
- other factors which management believes affect the allowance for potential credit losses.

Management uses several measures to assess and monitor the credit risks in the loan portfolio, including a loan grading system that begins upon loan origination and continues until the loan is collected or collectibility becomes doubtful. Upon loan origination, the Bank's originating loan officer evaluates the quality of the loan and assigns one of eight risk grades. The loan officer monitors the loan's performance and credit quality and makes changes to the credit grade as conditions warrant. When originated or renewed, all loans over a certain dollar amount receive in-depth reviews and risk assessments by the Bank's Credit Administration. Before making any changes in these risk grades, management considers assessments as determined by the third party credit review firm (as described below), regulatory examiners and the Bank's Credit Administration. Any issues regarding the risk assessments are addressed by the Bank's senior credit administrators and factored into management's decision to originate or renew the loan. The Bank's Board of Directors reviews, on a monthly basis, an analysis of the Bank's reserves relative to the range of reserves estimated by the Bank's Credit Administration.

As an additional measure, the Bank engages an independent third party to review the underwriting, documentation and risk grading analyses. This independent third party reviews and evaluates loan relationships greater than $1.0 million, excluding loans in default, loans in process of litigation or liquidation and loans that have been reviewed by regulatory examiners within six months prior to the independent third party review. The third party's evaluation and report is shared with management and the Bank's Board of Directors.

Management considers certain commercial loans with weak credit risk grades to be individually impaired and measures such impairment based upon available cash flows and the value of the collateral. Allowance or reserve levels are estimated for all other graded loans in the portfolio based on their assigned credit risk grade, type of loan and other matters related to credit risk.

Management uses the information developed from the procedures described above in evaluating and grading the loan portfolio. This continual grading process is used to monitor the credit quality of the loan portfolio and to assist management in estimating the allowance for loan losses.

The allowance for loan losses is comprised of three components: specific reserves, general reserves and unallocated reserves. After a loan has been identified as impaired, management measures impairment. When the measure of the impaired loan is less than the recorded investment in the loan, the amount of the impairment is recorded as a specific reserve. These specific reserves are determined on an individual loan basis based on management's current evaluation of the Bank's loss exposure for each credit, given the appraised value of any underlying collateral. Loans for which specific reserves are provided are excluded from the general allowance calculations as described below.

The general allowance reflects reserves established under GAAP for collective loan impairment. These reserves are based upon historical net charge-offs using the greater of the last two or three years' loss experience. This charge-off experience may be adjusted to reflect the effects of current conditions. The Bank considers information derived from its loan risk ratings and external data related to industry and general economic trends in establishing reserves.

The unallocated allowance is determined through management's assessment of probable losses that are in the portfolio but are not adequately captured by the other two components of the allowance, including consideration of current economic and business conditions and regulatory requirements. The unallocated allowance also reflects management's acknowledgement of the imprecision and subjectivity that underlie the modeling of credit risk. Due to the subjectivity involved in determining the overall allowance, including the unallocated portion, the unallocated portion may fluctuate from period to period based on management's evaluation of the factors affecting the assumptions used in calculating the allowance.

Management considers the allowance for loan losses adequate to cover the estimated losses inherent in the Bank's loan portfolio as of the date of the financial statements. Management believes it has established the allowance in accordance with GAAP and in consideration of the current economic environment. Although management uses the best information available to make evaluations, significant future additions to the allowance may be necessary based on changes in economic and other conditions, thus adversely affecting the operating results of the Company.

There were no significant changes in the estimation methods or fundamental assumptions used in the evaluation of the allowance for loan losses for the three months ended March 31, 2013 as compared to the year ended December 31, 2012. Revisions, estimates and assumptions may be made in any period in which the supporting factors indicate that loss levels may vary from the previous estimates.

Effective December 31, 2012, stated income mortgage loans from the Banco de la Gente division of the Bank were analyzed separately from other single family residential loans in the Bank's loan portfolio. These loans are first mortgage loans made to the Latino market, primarily in Mecklenburg and surrounding counties. These loans are non-traditional mortgages in that the customer normally did not have a credit history, so all credit information was accumulated by the loan officers. These loans were made as stated income loans rather than full documentation loans because the customer may not have had complete documentation on the income supporting the loan.

Various regulatory agencies, as an integral part of their examination process, periodically review the Bank's allowance for loan losses. Such agencies may require adjustments to the allowance based on their judgments of information available to them at the time of their examinations. Management believes it has established the allowance for credit losses pursuant to GAAP, and has taken into account the views of its regulators and the current economic environment.

The allowance for loan losses at March 31, 2013 was $14.4 million or 2.36% of total loans compared to $14.4 million or 2.33% of total loans at December 31, 2012.

The following table presents the percentage of loans assigned to each risk grade at March 31, 2013 and December 31, 2012.

Risk Grade	Percentage of Loans By Risk Grade 03/31/2013	12/31/2012
Risk Grade 1 (Excellent Quality)	2.86%	2.93%
Risk Grade 2 (High Quality)	17.32%	16.94%
Risk Grade 3 (Good Quality)	48.29%	47.74%
Risk Grade 4 (Management Attention)	19.00%	20.70%
Risk Grade 5 (Watch)	5.41%	5.07%
Risk Grade 6 (Substandard)	6.80%	6.26%
Risk Grade 7 (Doubtful)	0.00%	0.00%
Risk Grade 8 (Loss)	0.00%	0.00%

At March 31, 2013, including non-accrual loans, there were nine relationships exceeding $1.0 million in the Watch risk grade (which totaled $16.7 million) and four relationships exceeding $1.0 million in the Substandard risk grade (which totaled $11.3 million). At March 31, 2013, there were four relationships with loans in the Watch risk grade and the Substandard risk grade exceeding $1.0 million total (which totaled $5.7 million).

Non-performing Assets. Non-performing assets totaled $24.3 million at March 31, 2013 or 2.39% of total assets, compared to $26.3 million at December 31, 2012, or 2.60% of total assets. Non-accrual loans were $19.7 million at March 31, 2013 and $17.6 million at December 31, 2012. As a percentage of total loans outstanding, non-accrual loans were 3.22% at March 31, 2013 compared to 2.84% at December 31, 2012. Non-performing loans include $9.6 million in construction and land development loans, $9.3 million in commercial and residential mortgage loans and $728,000 in other loans at March 31, 2013 as compared to $9.2 million in construction and land development loans, $10.4 million in commercial and residential mortgage loans and $416,000 in other loans as of December 31, 2012. The Bank had loans 90 days past due and still accruing totaling $50,000 and $2.4 million as of March 31, 2013 and December 31, 2012, respectively. Other real estate totaled $4.6 million as of March 31, 2013 as compared to $6.3 million at December 31, 2012. Repossessed assets were $12,000 and $10,000 as of March 31, 2013 and December 31, 2012, respectively.

Deposits. Total deposits at March 31, 2013 were $783.8 million compared to $781.5 million at December 31, 2012. Core deposits, which include non-interest bearing demand deposits, NOW, MMDA, savings and non-brokered certificates of deposits of denominations less than $100,000, were $656.0 million at March 31, 2013 as compared to $646.4 million at December 31, 2012. Certificates of deposit in amounts of $100,000 or more totaled $127.8 million at March 31, 2013 as compared to $134.7 million at December 31, 2012. This decrease is attributable to a $3.0 million decrease in brokered certificates of deposit combined with a decrease in retail certificates of deposit as intended as part of the Bank's pricing strategy to allow maturing high cost certificates of deposit to roll-off. At March 31, 2013, brokered deposits were $18.5 million as compared to $21.4 million at December 31, 2012. Brokered deposits outstanding as of March 31, 2013 had a weighted average rate of 0.23% with a weighted average original term of ten months as compared to brokered deposits outstanding at December 31, 2012, which had a weighted average rate of 0.29% with a weighted average original term of ten months.

Borrowed Funds. Borrowings from the FHLB totaled $70.0 million at March 31, 2013 and December 31, 2012, respectively. The average balance of FHLB borrowings for the three months ended March 31, 2013 was $70.0 million compared to $70.4 million for the year ended December 31, 2012. At March 31, 2013, all of the Bank's FHLB borrowings had maturities exceeding one year.

Securities sold under agreements to repurchase were $37.4 million at March 31, 2013 compared to $34.6 million at December 31, 2012.

Junior Subordinated Debentures (related to Trust Preferred Securities). In June 2006, the Company formed a wholly owned Delaware statutory trust, PEBK Capital Trust II ("PEBK Trust II"), which issued $20.0 million of guaranteed preferred beneficial interests in the Company's junior subordinated deferrable interest debentures. All of the common securities of PEBK Trust II are owned by the Company. The proceeds from the issuance of the common securities and the trust preferred securities were used by PEBK Trust II to purchase $20.6 million of junior subordinated debentures of the Company, which pay a floating rate equal to three-month LIBOR plus 163 basis points. The proceeds received by the Company from the sale of the junior subordinated debentures were used to repay in December 2006 the trust preferred securities issued in December 2001 by PEBK Capital Trust, a wholly owned Delaware statutory trust of the Company, and for general purposes. The debentures represent the sole asset of PEBK Trust II. PEBK Trust II is not included in the Consolidated Financial Statements.

The trust preferred securities issued by PEBK Trust II accrue and pay quarterly at a floating rate of three-month LIBOR plus 163 basis points. The Company has guaranteed distributions and other payments due on the trust preferred securities to the extent PEBK Trust II does not have funds with which to make the distributions and other payments. The net combined effect of the trust preferred securities transaction is that the Company is obligated to make the distributions and other payments required on the trust preferred securities.

These trust preferred securities are mandatorily redeemable upon maturity of the debentures on June 28, 2036, or upon earlier redemption as provided in the indenture. The Company has the right to redeem the debentures purchased by PEBK Trust II, in whole or in part, which became effective on June 28, 2011. As specified in the indenture, if the debentures are redeemed prior to maturity, the redemption price will be the principal amount and any accrued but unpaid interest.

Asset Liability and Interest Rate Risk Management. The objective of the Company's Asset Liability and Interest Rate Risk strategies is to identify and manage the sensitivity of net interest income to changing interest rates and to minimize the interest rate risk between interest-earning assets and interest-bearing liabilities at various maturities. This is to be done in conjunction with the need to maintain adequate liquidity and the overall goal of maximizing net interest income.

The Company manages its exposure to fluctuations in interest rates through policies established by our Asset/Liability Committee ("ALCO"). ALCO meets monthly and has the responsibility for approving asset/liability management policies, formulating and implementing strategies to improve balance sheet positioning and/or earnings and reviewing the interest rate sensitivity of the Company. ALCO tries to minimize interest rate risk between interest-earning assets and interest-bearing liabilities by attempting to minimize wide fluctuations in net interest income due to interest rate movements. The ability to control these fluctuations has a direct impact on the profitability of the Company. Management monitors this activity on a regular basis through analysis of its portfolios to determine the difference between rate sensitive assets and rate sensitive liabilities.

The Company's rate sensitive assets are those earning interest at variable rates and those with contractual maturities within one year. Rate sensitive assets therefore include both loans and available for sale securities. Rate sensitive liabilities include interest-bearing checking accounts, money market deposit accounts, savings accounts, time deposits and borrowed funds. Average rate sensitive assets for the three months ended March 31, 2013 totaled $936.8 million, exceeding average rate sensitive liabilities of $738.2 million by $198.6 million.

The Company has an overall interest rate risk management strategy that incorporates the use of derivative instruments to minimize significant unplanned fluctuations in earnings that are caused by interest rate volatility. By using derivative instruments, the Company is exposed to credit and market risk. If the counterparty fails to perform, credit risk is equal to the extent of the fair-value gain in the derivative. The Company minimizes the credit risk in derivative instruments by entering into transactions with high-quality counterparties that are reviewed periodically by the Company. The Company did not have any interest rate derivatives outstanding as of March 31, 2013.

Included in the rate sensitive assets are $311.3 million in variable rate loans indexed to prime rate subject to immediate repricing upon changes by the Federal Open Market Committee ("FOMC"). We utilize interest rate floors on certain variable rate loans to protect against further downward movements in the prime rate. At March 31, 2013, we had $235.7 million in loans with interest rate floors. The floors were in effect on $233.9 million of these loans pursuant to the terms of the promissory notes on these loans. The weighted average rate on these loans is 1.08% higher than the indexed rate on the promissory notes without interest rate floors.

Liquidity. The objectives of the Company's liquidity policy are to provide for the availability of adequate funds to meet the needs of loan demand, deposit withdrawals, maturing liabilities and to satisfy regulatory requirements. Both deposit and loan customer cash needs can fluctuate significantly depending upon business cycles, economic conditions and yields and returns available from alternative investment opportunities. In addition, the Company's liquidity is affected by off-balance sheet commitments to lend in the form of unfunded commitments to extend credit and standby letters of credit. As of March 31, 2013, such unfunded commitments to extend credit were $131.2 million, while commitments in the form of standby letters of credit totaled $3.4 million.

The Company uses several sources to meet its liquidity requirements. The primary source is core deposits, which includes demand deposits, savings accounts and non-brokered certificates of deposits of denominations less than $100,000. The Company considers these to be a stable portion of the Company's liability mix and the result of on-going consumer and commercial banking relationships. As of March 31, 2013, the Company's core deposits totaled $656.0 million, or 84% of total deposits.

The other sources of funding for the Company are through large denomination certificates of deposit, including brokered deposits, federal funds purchased, securities under agreements to repurchase and FHLB borrowings. The Bank is also able to borrow from the Federal Reserve Bank ("FRB") on a short-term basis. Our policies include the ability to access wholesale funding up to 40% of total assets. Our wholesale funding includes FHLB borrowings, FRB borrowings, brokered deposits, internet certificates of deposit and certificates of deposit issued to the State of North Carolina. The Company's ratio of wholesale funding to total assets was 8.74% as of March 31, 2013.

At March 31, 2013, we had a significant amount of deposits in amounts greater than $100,000. The cost of these deposits is more susceptible to changes in the interest rate environment than other deposits. Access to the brokered deposit market could be restricted if the Bank were to fall below the well capitalized level.

The Bank has a line of credit with the FHLB equal to 20% of the Bank's total assets, with an outstanding balance of $70.0 million at March 31, 2013 and December 31, 2012. At March 31, 2013, the carrying value of loans pledged as collateral to the FHLB totaled $137.4 million compared to $138.7 million at December 31, 2012. As additional collateral, the Bank has pledged securities to the FHLB. At March 31, 2013, the market value of securities pledged to the FHLB totaled $19.6 million compared to $17.8 million at December 31, 2012. The remaining availability under the line of credit with the FHLB was $21.8 million at March 31, 2013 compared to $20.4 million at December 31, 2012. The Bank had no borrowings from the FRB at March 31, 2013 and December 31, 2012. FRB borrowings are collateralized by a blanket assignment on all qualifying loans that the Bank owns which are not pledged to the FHLB. At March 31, 2013, the carrying value of loans pledged as collateral to the FRB totaled $304.5 million compared to $313.7 million at December 31, 2012.

The Bank also had the ability to borrow up to $52.5 million for the purchase of overnight federal funds from five correspondent financial institutions as of March 31, 2013.

The liquidity ratio for the Bank, which is defined as net cash, interest-bearing deposits, federal funds sold and certain investment securities, as a percentage of net deposits and short-term liabilities was 32.82% at March 31, 2013 and 35.14% at December 31, 2012. The minimum required liquidity ratio as defined in the Bank's Asset/Liability and Interest Rate Risk Management Policy is 10%.

Contractual Obligations and Off-Balance Sheet Arrangements. The Company's contractual obligations and other commitments as of March 31, 2013 and December 31, 2012 are summarized in the table below. The Company's contractual obligations include the repayment of principal and interest related to FHLB advances and junior subordinated debentures, as well as certain payments under current lease agreements. Other commitments include commitments to extend credit. Because not all of these commitments to extend credit will be drawn upon, the actual cash requirements are likely to be significantly less than the amounts reported for other commitments below.

(Dollars in thousands)

		March 31, 2013	December 31, 2012
Contractual Cash Obligations			
Long-term borrowings	$	70,000	70,000
Junior subordinated debentures		20,619	20,619
Operating lease obligations		4,163	4,117
Total	$	94,782	94,736
Other Commitments			
Commitments to extend credit	$	131,153	133,919
Standby letters of credit and financial guarantees written		3,386	3,297
Total	$	134,539	137,216

The Company enters into derivative contracts to manage various financial risks. A derivative is a financial instrument that derives its cash flows, and therefore its value, by reference to an underlying instrument, index or referenced interest rate. Derivative contracts are carried at fair value on the consolidated balance sheet with the fair value representing the net present value of expected future cash receipts or payments based on market interest rates as of the balance sheet date. Derivative contracts are written in amounts referred to as notional amounts, which only provide the basis for calculating payments between counterparties and are not a measure of financial risk. Further discussions of derivative instruments are included above in the section entitled “Asset Liability and Interest Rate Risk Management”.

Capital Resources. Shareholders’ equity at March 31, 2013 was $98.3 million compared to $97.7 million at December 31, 2012. This increase was due to an increase in retained earnings attributable to first quarter 2013 net income, which was partially offset by a decrease in accumulated other comprehensive income.

During 2012, the Company purchased 12,530 shares of the Company's 25,054 outstanding shares of Series A preferred stock from the UST. The shares were purchased for $933.36 per share, for a total purchase price of $11,778,576, including $83,575 accrued and unpaid dividends on the Series A preferred stock. The Company retired the 12,530 shares purchased. The $834,999 difference between the $12,530,000 face value of the Series A preferred stock retired and the $11,695,001 purchase price of the Series A preferred stock retired was credited to retained earnings effective June 30, 2012. Remaining Series A preferred shares are redeemable at any time at par. The Company expects to be able to repurchase the shares from future earnings, however, there are no immediate plans to repurchase these shares.

During 2012, the Company completed its repurchase of the Warrant to purchase 357,234 shares of the Company's common stock that was issued to the UST. The Company repurchased the Warrant for a total price of $425,000.

Annualized return on average equity for the three months ended March 31, 2013 was 7.17% compared to 5.58% for the year ended December 31, 2012. Total cash dividends paid on common stock were $168,000 and $388,000 for the three months ended March 31, 2013 and 2012, respectively. Cash dividends paid on common stock in the three months ended March 31, 2012 include a $0.05 per share special cash dividend, amounting to $277,000, paid in February 2012.

The Board of Directors, at its discretion, can issue shares of preferred stock up to a maximum of 5,000,000 shares. The Board is authorized to determine the number of shares, voting powers, designations, preferences, limitations and relative rights. The Board of Directors does not currently anticipate issuing any additional series of preferred stock.

Under the regulatory capital guidelines, financial institutions are currently required to maintain a total risk-based capital ratio of 8.0% or greater, with a Tier 1 risk-based capital ratio of 4.0% or greater. Tier 1 capital is generally defined as shareholders' equity and trust preferred securities less all intangible assets and goodwill. Tier 1 capital at March 31, 2013 and December 31, 2012 includes $20.0 million in trust preferred securities. The Company's Tier 1 capital ratio was 16.75% and 16.04% at March 31, 2013 and December 31, 2012, respectively. Total risk-based capital is defined as Tier 1 capital plus supplementary capital. Supplementary capital, or Tier 2 capital, consists of the Company's allowance for loan losses, not exceeding 1.25% of the Company's risk-weighted assets. Total risk-based capital ratio is therefore defined as the ratio of total capital (Tier 1 capital and Tier 2 capital) to risk-weighted assets. The Company's total risk-based capital ratio was 18.06% and 17.34% at March 31, 2013 and December 31, 2012, respectively. In addition to the Tier 1 and total risk-based capital requirements, financial institutions are also required to maintain a leverage ratio of Tier 1 capital to total average assets of 4.0% or greater. The Company's Tier 1 leverage capital ratio was 11.31% and 11.12% at March 31, 2013 and December 31, 2012, respectively.

The Bank's Tier 1 risk-based capital ratio was 16.29% and 15.54% at March 31, 2013 and December 31, 2012, respectively. The total risk-based capital ratio for the Bank was 17.60% and 16.84% at March 31, 2013 and December 31, 2012, respectively. The Bank's Tier 1 leverage capital ratio was 10.98% and 10.76% at March 31, 2013 and December 31, 2012, respectively.

A bank is considered to be "well capitalized" if it has a total risk-based capital ratio of 10.0 % or greater, a Tier 1 risk-based capital ratio of 6.0% or greater, and a leverage ratio of 5.0% or greater. Based upon these guidelines, the Bank was considered to be "well capitalized" at March 31, 2013.

Subsequent Events. The Company has reviewed and evaluated subsequent events and transactions for material subsequent events through the date the financial statements are issued. Management has concluded that there were no material subsequent events.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Not required for smaller reporting companies.

Item 4T. Controls and Procedures

The Company's management, with the participation of the Company's Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the Company's disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) as of the end of the period covered by this report. Based on such evaluation, the Company's Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of such period, the Company's disclosure controls and procedures are effective in recording, processing, summarizing and reporting, on a timely basis, information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act.

There have not been any changes in the Company's internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the fiscal quarter to which this report relates that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

On April 2, 2013, the Bank received notice that a lawsuit was filed against it in the General Court of Justice, Superior Court Division, Lincoln County, North Carolina. The complaint alleges (i) breach of contract and the covenants of good faith and fair dealing by the Bank, (ii) conversion, (iii) unjust enrichment and (iv) violations of the North Carolina Unfair and Deceptive Trade Practices Act in its assessment and collection of overdraft fees. It seeks the refund of overdraft fees, treble damages, attorneys' fees and injunctive relief. The Plaintiff seeks to have the lawsuit certified as a class action. The Bank believes that the allegations in the complaint are without merit and intends to vigorously defend the lawsuit, including the request that the lawsuit be certified as a class action.

Item 1A. Risk Factors

Not required for smaller reporting companies.

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

ISSUER PURCHASES OF EQUITY SECURITIES

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs
January 1 - 31, 2013	-	$ -	-	-
February 1 - 28, 2013	1,255	10.59	-	-
March 1 - 31, 2013	890	11.65	-	-

Total	2,145	(1)	$	11.03	-

(1) The Company purchased 2,145 shares on the open market in the three months ended March 31, 2013 for its deferred compensation plan. All purchases were funded by participant contributions to the plan.

Item 3.Defaults Upon Senior Securities

Not applicable

Item 5.Other Information

Not applicable

Item 6.Exhibits

Exhibit (3)(1) Articles of Amendment dated December 19, 2008, regarding the Series A Preferred Stock, incorporated by reference to Exhibit (3)(1) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008

Exhibit (3)(2) Articles of Amendment dated February 26, 2010, incorporated by reference to Exhibit (3)(2) to the Form 10-K filed with the Securities and Exchange Commission on March 25, 2010

Exhibit (3)(i)	Articles of Incorporation of the Registrant, incorporated by reference to Exhibit (3)(i) to the Form 8-A filed with the Securities and Exchange Commission on September 2, 1999
Exhibit (3)(ii)	Amended and Restated Bylaws of the Registrant, incorporated by reference to Exhibit (3)(ii) to the Form 10-K filed with the Securities and Exchange Commission on March 25, 2010
Exhibit (4)	Specimen Stock Certificate, incorporated by reference to Exhibit (4) to the Form 8-A filed with the Securities and Exchange Commission on September 2, 1999
Exhibit (4)(1)	Form of Certificate for the Series A Preferred Stock, incorporated by reference to Exhibit (4)(1) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008
Exhibit (10)(a)(iii)	Amended and Restated Executive Salary Continuation Agreement between Peoples Bank and Tony W. Wolfe dated December 18, 2008, incorporated by reference to Exhibit (10)(a)(iii) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008
Exhibit (10)(b)(i)	Employment Letter Agreement dated December 23, 2008 between the Registrant and Joseph F. Beaman, Jr., incorporated by reference to Exhibit (10(b)(i) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008
Exhibit (10)(b)(ii)	Amendment to Employment Agreement between Peoples Bank and Joseph F. Beaman, Jr. dated December 18, 2008, incorporated by reference to Exhibit (10)(b)(ii) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008
Exhibit (10)(b)(iii)	Amended and Restated Executive Salary Continuation Agreement between Peoples Bank and Joseph F. Beaman, Jr. dated December 18, 2008, incorporated by reference to Exhibit (10)(b)(iii) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008
Exhibit (10)(c)(i)	Employment Letter Agreement dated December 23, 2008 between the Registrant and William D. Cable, Sr., incorporated by reference to Exhibit (10(c)(i) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008
Exhibit (10)(c)(ii)	Amendment to Employment Agreement between Peoples Bank and William D. Cable, Sr. dated December 18, 2008, incorporated by reference to Exhibit

	(10)(c)(ii) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008
Exhibit (10)(c)(iii)	Amended and Restated Executive Salary Continuation Agreement between Peoples Bank and William D. Cable, Sr. dated December 18, 2008, incorporated by reference to Exhibit (10)(c)(iii) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008
Exhibit (10)(d)(i)	Employment Letter Agreement dated December 23, 2008 between the Registrant and Lance A. Sellers, incorporated by reference to Exhibit (10(d)(i) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008
Exhibit (10)(d)(ii)	Amendment to Employment Agreement between Peoples Bank and Lance A. Sellers dated December 18, 2008, incorporated by reference to Exhibit (10)(d)(ii) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008

Exhibit (10)(d)(iii)	Amended and Restated Executive Salary Continuation Agreement between Peoples Bank and Lance A. Sellers dated December 18, 2008, incorporated by reference to Exhibit (10)(d)(iii) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008
Exhibit (10)(e)	Peoples Bancorp of North Carolina, Inc. Omnibus Stock Ownership and Long Term Incentive Plan incorporated by reference to Exhibit (10)(f) to the Form 10-K filed with the Securities and Exchange Commission on March 30, 2000
Exhibit (10)(e)(i)	Amendment No. 1 to the Peoples Bancorp of North Carolina, Inc. Omnibus Stock Ownership and Long Term Incentive Plan incorporated by reference to Exhibit (10)(e)(i) to the Form 10-K filed with the Securities and Exchange Commission on March 15, 2007
Exhibit (10)(f)(i)	Employment Letter Agreement dated December 23, 2008 between the Registrant and A. Joseph Lampron, Jr., incorporated by reference to Exhibit (10(f)(i) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008
Exhibit (10)(f)(ii)	Amendment to Employment Agreement between Peoples Bank and A. Joseph Lampron, Jr. dated March 18, 2010 incorporated by reference to Exhibit (10)(f)(ii) to the Form 10-K filed with the Securities and Exchange Commission on March 25, 2010
Exhibit (10)(f)(iii)	Amended and Restated Executive Salary Continuation Agreement between Peoples Bank and A. Joseph Lampron, Jr. dated December 18, 2008, incorporated by reference to Exhibit (10)(f)(iii) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008
Exhibit (10)(g)	Peoples Bank Directors' and Officers' Deferral Plan, incorporated by reference to Exhibit (10)(h) to the Form 10-K filed with the Securities and Exchange Commission on March 28, 2002
Exhibit (10)(h)	Rabbi Trust for the Peoples Bank Directors' and Officers' Deferral Plan, incorporated by reference to Exhibit (10)(i) to the Form 10-K filed with the Securities and Exchange Commission on March 28, 2002
Exhibit (10)(i)	Description of Service Recognition Program maintained by Peoples Bank, incorporated by reference to Exhibit (10)(i) to the Form 10-K filed with the

Securities and Exchange Commission on March 27, 2003

Exhibit (10)(j)	Capital Securities Purchase Agreement dated as of June 26, 2006, by and among the Registrant, PEBK Capital Trust II and Bear, Sterns Securities Corp., incorporated by reference to Exhibit (10)(j) to the Form 10-Q filed with the Securities and Exchange Commission on November 13, 2006
Exhibit (10)(k)	Amended and Restated Trust Agreement of PEBK Capital Trust II, dated as of June 28, 2006, incorporated by reference to Exhibit (10)(k) to the Form 10-Q filed with the Securities and Exchange Commission on November 13, 2006
Exhibit (10)(l)	Guarantee Agreement of the Registrant dated as of June 28, 2006, incorporated by reference to Exhibit (10)(l) to the Form 10-Q filed with the Securities and Exchange Commission on November 13, 2006
Exhibit (10)(m)	Indenture, dated as of June 28, 2006, by and between the Registrant and LaSalle Bank National Association, as Trustee, relating to Junior Subordinated Debt Securities Due September 15, 2036, incorporated by reference to Exhibit (10)(m) to the Form 10-Q filed with the Securities and Exchange Commission on November 13, 2006

Exhibit (10)(n)	Form of Amended and Restated Director Supplemental Retirement Agreement between Peoples Bank and Directors Robert C. Abernethy, James S. Abernethy, Douglas S. Howard, John W. Lineberger, Jr., Gary E. Matthews, Dr. Billy L. Price, Jr., Larry E. Robinson, W. Gregory Terry, Dan Ray Timmerman, Sr. and Benjamin I. Zachary, incorporated by reference to Exhibit (10)(n) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008
Exhibit (10)(o)	2009 Omnibus Stock Ownership and Long Term Incentive Plan incorporated by reference to Exhibit (10)(o) to the Form 10-K filed with the Securities and Exchange Commission on March 20, 2009
Exhibit (10)(p)	Underwriting Agreement with Merrill Lynch, Pierce, Fenner & Smith Incorporated and Sandler O'Neill & Partners, L.P., as representatives of the several underwriters listed on Schedule A thereto and the UST incorporated by reference to Exhibit 1.1 to the Form 8-K filed with the Securities and Exchange Commission on June 29, 2012
Exhibit (14)	Code of Business Conduct and Ethics of Peoples Bancorp of North Carolina, Inc., incorporated by reference to Exhibit (14) to the Form 10-K filed with the Securities and Exchange Commission on March 25, 2005
Exhibit (31)(a)	Certification of principal executive officer pursuant to section 302 of the Sarbanes-Oxley Act of 2002
Exhibit (31)(b)	Certification of principal financial officer pursuant to section 302 of the Sarbanes-Oxley Act of 2002
Exhibit (32)	Certification Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
Exhibit (101)	The following materials from the Company's 10-Q Report for the quarterly period ended March 31, 2013, formatted in XBRL: (i) the Condensed Consolidated Balance Sheets, (ii) the Condensed Consolidated Statements of Income, (iii) the Condensed Consolidated Statements of Changes in Shareholders' Equity, (iv) the Condensed Consolidated Statements of Cash Flows, and (v) the Notes to the Condensed Consolidated Financial Statements, tagged as blocks of text.*

*Furnished, not filed.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Peoples Bancorp of North Carolina, Inc.

May 10, 2013	/s/ Lance A. Sellers
Date	Lance A. Sellers President and Chief Executive Officer (Principal Executive Officer)
May 10, 2013	/s/ A. Joseph Lampron, Jr.
Date	A. Joseph Lampron, Jr. Executive Vice President and Chief Financial Officer (Principal Financial and Principal Accounting Officer)