FIRST BUSINESS FINANCIAL SERVICES, INC.
Form 10-Q
October 26, 2012

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q
þ Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.
For the quarterly period ended September 30, 2012
OR
¨ Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
Commission file number 001-34095
FIRST BUSINESS FINANCIAL SERVICES, INC.
(Exact name of registrant as specified in its charter)

Wisconsin	39-1576570
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
401 Charmany Drive Madison, WI	53719
(Address of Principal Executive Offices)	(Zip Code)

(608) 238-8008
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 and Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes þ No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate website, if any, every Interactive Data Field 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 þ No ¨

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

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

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

The number of shares outstanding of the registrant’s sole class of common stock, par value $0.01 per share, on October 19, 2012 was 2,656,102 shares.

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PART I. Financial Information
Item 1. Financial Statements
First Business Financial Services, Inc.
Consolidated Balance Sheets

	(unaudited) September 30, 2012	December 31, 2011
	(In Thousands, Except Share Data)	
Assets		
Cash and due from banks	$17,494	$16,707
Short-term investments	70,348	113,386
Cash and cash equivalents	87,842	130,093
Securities available-for-sale, at fair value	202,805	170,386
Loans and leases receivable, net of allowance for loan and lease losses of $14,706 and $14,155, respectively	863,486	836,687
Leasehold improvements and equipment, net	965	999
Foreclosed properties	2,187	2,236
Cash surrender value of bank-owned life insurance	18,068	17,660
Investment in Federal Home Loan Bank stock, at cost	1,144	2,367
Accrued interest receivable and other assets	15,638	16,737
Total assets	$1,192,135	$1,177,165
Liabilities and Stockholders' Equity		
Deposits	$1,061,258	$1,051,312
Federal Home Loan Bank and other borrowings	39,482	40,292
Junior subordinated notes	10,315	10,315
Accrued interest payable and other liabilities	10,531	11,032
Total liabilities	1,121,586	1,112,951
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, $0.01 par value, 2,500,000 shares authorized, none issued or outstanding	—	—
Common stock, $0.01 par value, 25,000,000 shares authorized, 2,745,750 and 2,714,985 shares issued, 2,656,102 and 2,625,569 shares outstanding at September 30, 2012 and December 31, 2011, respectively	27	27
Additional paid-in capital	26,217	25,843
Retained earnings	43,343	37,501
Accumulated other comprehensive income	2,632	2,491
Treasury stock (89,648 and 89,416 shares at September 30, 2012 and December 31, 2011, respectively), at cost	(1,670)	(1,648)
Total stockholders' equity	70,549	64,214
Total liabilities and stockholders' equity	$1,192,135	$1,177,165

See accompanying Notes to Unaudited Consolidated Financial Statements.

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First Business Financial Services, Inc.
Consolidated Statements of Income (Unaudited)

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2012	2011	2012	2011
	(In Thousands, Except Share Data)			
Interest income:				
Loans and leases	$13,095	$13,047	$38,859	$39,016
Securities income	890	1,048	2,575	3,272
Short-term investments	47	24	174	76
Total interest income	14,032	14,119	41,608	42,364
Interest expense:				
Deposits	3,102	4,107	10,178	13,107
Notes payable and other borrowings	735	628	2,145	1,868
Junior subordinated notes	280	280	835	832
Total interest expense	4,117	5,015	13,158	15,807
Net interest income	9,915	9,104	28,450	26,557
Provision for loan and lease losses	850	435	3,399	3,313
Net interest income after provision for loan and lease losses	9,065	8,669	25,051	23,244
Non-interest income:				
Trust and investment services fee income	736	622	2,178	1,918
Service charges on deposits	532	425	1,504	1,215
Loan fees	502	380	1,245	1,079
Increase in cash surrender value of bank-owned life insurance	178	170	524	504
Credit, merchant and debit card fees	50	53	169	163
Other	251	78	383	266
Total non-interest income	2,249	1,728	6,003	5,145
Non-interest expense:				
Compensation	4,224	3,840	12,455	11,413
Occupancy	294	351	958	1,050
Professional fees	400	369	1,279	1,141
Data processing	326	311	993	945
Marketing	300	295	845	823
Equipment	141	125	375	344
FDIC insurance	426	571	1,546	1,901
Collateral liquidation costs	264	155	451	574
Net (gain) loss on foreclosed properties	(14)	29	228	158
Other	890	704	2,085	1,799
Total non-interest expense	7,251	6,750	21,215	20,148
Income before income tax expense	4,063	3,647	9,839	8,241
Income tax expense	1,441	1,468	3,442	2,201
Net income	$2,622	$2,179	$6,397	$6,040
Earnings per common share:				
Basic	$0.99	$0.83	$2.43	$2.32
Diluted	0.99	0.83	2.43	2.32
Dividends declared per share	0.07	0.07	0.21	0.21

See accompanying Notes to Unaudited Consolidated Financial Statements.

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First Business Financial Services, Inc.
Consolidated Statements of Comprehensive Income (Unaudited)

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2012	2011	2012	2011
	(In Thousands)			
Net income	$2,622	$2,179	$6,397	$6,040
Other comprehensive income, before tax				
Unrealized securities gains (losses) arising during the period	419	(280)	227	893
Income tax (expense) benefit	(160)	103	(86)	(355)
Comprehensive income	$2,881	$2,002	$6,538	$6,578

See accompanying Notes to Unaudited Consolidated Financial Statements.

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First Business Financial Services, Inc.
Consolidated Statements of Changes in Stockholders' Equity (Unaudited)

	Common stock	Additional paid-in capital	Retained earnings	Accumulated other comprehensive income	Treasury stock	Total
	(In Thousands, Except Share Data)					
Balance at December 31, 2010	$27	$25,253	$29,808	$1,792	$(1,545)	$55,335
Net income	—	—	6,040	—	—	6,040
Other comprehensive income	—	—	—	538	—	538
Share-based compensation - restricted shares	—	439	—	—	—	439
Share-based compensation - tax benefits	—	—	—	—	—	—
Cash dividends ($0.21 per share)	—	—	(547)	—	—	(547)
Treasury stock purchased (3,181 shares)	—	—	—	—	(55)	(55)
Balance at September 30, 2011	$27	$25,692	$35,301	$2,330	$(1,600)	$61,750

	Common stock	Additional paid-in capital	Retained earnings	Accumulated other comprehensive income	Treasury stock	Total
	(In Thousands, Except Share Data)					
Balance at December 31, 2011	$27	$25,843	$37,501	$2,491	$(1,648)	$64,214
Net income	—	—	6,397	—	—	6,397
Other comprehensive income	—	—	—	141	—	141
Share-based compensation - restricted shares	—	403	—	—	—	403
Share-based compensation - tax benefits	—	48	—	—	—	48
Cash dividends ($0.21 per share)	—	—	(555)	—	—	(555)
Treasury stock purchased (4,390 shares)	—	—	—	—	(99)	(99)
Treasury stock re-issued (4,158 shares)	—	(77)	—	—	77	—
Balance at September 30, 2012	$27	$26,217	$43,343	$2,632	$(1,670)	$70,549

See accompanying Notes to Unaudited Consolidated Financial Statements.

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First Business Financial Services, Inc.
Consolidated Statements of Cash Flows (Unaudited)

	For the Nine Months Ended September 30, 2012	2011
	(In Thousands)	
Operating activities		
Net income	$6,397	$6,040
Adjustments to reconcile net income to net cash provided by operating activities:		
Deferred income taxes, net	(257)	1,124
Provision for loan and lease losses	3,399	3,313
Depreciation, amortization and accretion, net	2,315	1,638
Share-based compensation	403	439
Increase in cash surrender value of bank-owned life insurance	(524)	(504)
Origination of loans for sale	(1,548)	(1,283)
Sale of loans originated for sale	1,695	1,288
Gain on sale of loans originated for sale	(147)	(5)
Net loss on foreclosed properties	228	158
Excess tax benefit from share-based compensation	(48)	(2)
Decrease in accrued interest receivable and other assets	793	1,306
Decrease in accrued interest payable and other liabilities	(323)	(696)
Net cash provided by operating activities	12,383	12,816
Investing activities		
Proceeds from maturities of available-for-sale securities	41,497	31,299
Purchases of available-for-sale securities	(75,742)	(46,711)
Proceeds from sale of foreclosed properties	1,486	1,766
Payments to priority lien holders of foreclosed properties	(268)	—
Net (increase) decrease in loans and leases	(31,595)	8,741
Investment in Aldine Capital Fund, L.P.	—	(210)
Distributions from Aldine Capital Fund, L.P.	557	—
Proceeds from sale of FHLB Stock	1,223	—
Purchases of leasehold improvements and equipment, net	(441)	(274)
Premium payment on bank owned life insurance policies	—	(8)
Proceeds from surrender of bank owned life insurance policies	116	—
Net cash used in investing activities	(63,167)	(5,397)
Financing activities		
Net increase in deposits	9,946	24,830
Repayment of FHLB advances	(10)	(2,009)
Net decrease in short-term borrowed funds	(800)	—
Proceeds from issuance of subordinated notes payable	6,215	—
Repayment of subordinated notes payable	(6,215)	—
Excess tax benefit from share-based compensation	48	2
Cash dividends paid	(552)	(545)
Purchase of treasury stock	(99)	(55)
Net cash provided by financing activities	8,533	22,223
Net (decrease) increase in cash and cash equivalents	(42,251)	29,642
Cash and cash equivalents at the beginning of the period	130,093	50,819
Cash and cash equivalents at the end of the period	$87,842	$80,461
Supplementary cash flow information		

Interest paid on deposits and borrowings	$13,149	$16,137
Income taxes paid	3,874	2,950
Transfer to foreclosed properties	1,397	2,218
Reissuance of treasury stock	77	—

See accompanying Notes to Unaudited Consolidated Financial Statements.

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Notes to Unaudited Consolidated Financial Statements

Note 1 — Nature of Operations and Summary of Significant Accounting Policies

Nature of Operations. First Business Financial Services, Inc. (together with all of its subsidiaries, collectively referred to as “FBFS” or the “Corporation”) is a registered bank holding company incorporated under the laws of the State of Wisconsin and is engaged in the commercial banking business through its wholly owned subsidiaries First Business Bank (“FBB”) and First Business Bank — Milwaukee (“FBB-Milwaukee”). FBB and FBB-Milwaukee are sometimes referred to together as the “Banks.” FBB operates as a commercial banking institution in Dane County and the surrounding areas with loan production offices in Oshkosh, Appleton, and Green Bay, Wisconsin. FBB also offers trust and investment services through First Business Trust & Investments, a division of FBB. FBB — Milwaukee operates as a commercial banking institution in Waukesha County and the surrounding areas. The Banks provide a full range of financial services to businesses, business owners, executives, professionals and high net worth individuals. The Banks are subject to competition from other financial institutions and service providers and are also subject to state and federal regulations. FBB has the following subsidiaries: First Business Capital Corp., First Madison Investment Corp., First Business Equipment Finance, LLC and FBB Real Estate, LLC. First Madison Investment Corp. is located in and was formed under the laws of the state of Nevada. FBB-Milwaukee has one subsidiary, FBB — Milwaukee Real Estate, LLC.

Principles of Consolidation. The unaudited consolidated financial statements include the accounts and results of the Corporation. In accordance with the provisions of Accounting Standards Codification (ASC) Topic 810, the Corporation’s ownership interest in FBFS Statutory Trust II (“Trust II”) has not been consolidated into the financial statements. All significant intercompany balances and transactions were eliminated in consolidation.

Basis of Presentation. The accompanying unaudited consolidated financial statements were prepared in accordance with U.S. generally accepted accounting principles (“GAAP”) and with the instructions to Form 10-Q and Rule 8-03 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. The Corporation has not changed its significant accounting and reporting policies from those disclosed in the Corporation’s Form 10-K for the year ended December 31, 2011 except as described further below in this Note 1.

In the opinion of management, all adjustments (consisting of normal recurring accruals) necessary for a fair presentation of the unaudited consolidated financial statements were included in the unaudited consolidated financial statements. The results of operations for the three and nine month periods ended September 30, 2012 are not necessarily indicative of results that may be expected for any other interim period or the entire fiscal year ending December 31, 2012. Certain amounts in prior periods may have been reclassified to conform to the current presentation. Subsequent events were evaluated through the issuance of the unaudited consolidated financial statements.

Note 2 — Earnings Per Common Share

Earnings per common share are computed using the two-class method. Basic earnings per common share are computed by dividing net income allocated to common shares by the weighted average number of shares outstanding during the applicable period, excluding outstanding participating securities. Participating securities include unvested restricted shares. Unvested restricted shares are considered participating securities because holders of these securities receive non-forfeitable dividends at the same rate as holders of the Corporation’s common stock. Diluted earnings per share are computed by dividing net income allocated to common shares adjusted for reallocation of undistributed earnings of unvested restricted shares by the weighted average number of shares determined for the basic earnings per common share computation plus the dilutive effect of common stock equivalents using the treasury stock method.

For the three month periods ended September 30, 2012 and 2011, average anti-dilutive employee share-based awards totaled 54,000 and 146,979, respectively. For the nine month periods ended September 30, 2012 and 2011, average anti-dilutive employee share-based awards totaled 120,502 and 145,526, respectively.

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	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2012	2011	2012	2011
	(Dollars in Thousands, Except Share Data)			
Basic earnings per common share				
Net income	$2,622	$2,179	$6,397	$6,040
Less: earnings allocated to participating securities	101	83	239	230
Basic earnings allocated to common shareholders	$2,521	$2,096	$6,158	$5,810
Weighted-average common shares outstanding, excluding participating securities	2,539,507	2,511,767	2,533,436	2,502,991
Basic earnings per common share	$0.99	$0.83	$2.43	$2.32
Diluted earnings per common share				
Earnings allocated to common shareholders	$2,521	$2,096	$6,158	$5,810
Reallocation of undistributed earnings	—	(1)	—	—
Diluted earnings allocated to common shareholders	$2,521	$2,095	$6,158	$5,810
Weighted-average common shares outstanding, excluding participating securities	2,539,507	2,511,767	2,533,436	2,502,991
Dilutive effect of share-based awards	4,978	50	1,752	—
Weighted-average diluted common shares outstanding, excluding participating securities	2,544,485	2,511,817	2,535,188	2,502,991
Diluted earnings per common share	$0.99	$0.83	$2.43	$2.32

Note 3 — Share-Based Compensation

The Corporation adopted the 2012 Equity Incentive Plan (the “Plan”) during the quarter ended June 30, 2012. The Plan is administered by the Compensation Committee of the Board of Directors of FBFS and provides for the grant of equity ownership opportunities through incentive stock options and nonqualified stock options (“Stock Options”), restricted stock, restricted stock units, dividend equivalent unit, and any other type of award permitted by the Plan. Shares previously available for grant under the 2006 Equity Incentive Plan (the "2006 Plan") were transferred to the 2012 Equity Incentive Plan. As of September 30, 2012, 214,634 shares were available for future grants under the Plan. Shares covered by awards that expire, terminate or lapse will again be available for the grant of awards under the Plan. The Corporation may issue new shares and shares from treasury for shares delivered under the Plan. The 2006 Plan was terminated on May 14, 2012.

Stock Options

The Corporation may grant Stock Options to senior executives and other employees under the Plan. Stock Options generally have an exercise price that is equal to the fair value of the common shares on the date the option is awarded. Stock Options granted under the plans are subject to graded vesting, generally ranging from 4 years to 8 years, and have a contractual term of 10 years. For any new awards issued, compensation expense is recognized over the requisite service period for the entire award on a straight-line basis. No Stock Options were granted since the Corporation became a reporting company under the Securities Exchange Act of 1934 and no Stock Options were modified, repurchased or cancelled. Therefore, no stock-based compensation related to Stock Options was recognized in the consolidated financial statements for the three and nine months ended September 30, 2012 and 2011. As of September 30, 2012, all Stock Options granted and not previously forfeited have vested.

Stock Option activity for the year ended December 31, 2011 and nine months ended September 30, 2012 was as follows:

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	Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (Years)
Outstanding at December 31, 2010	138,766	$22.09	2.75
Granted	—	—	
Exercised	—	—	
Expired	(13,732)	19.00	
Forfeited	—	—	
Outstanding at December 31, 2011	125,034	$22.43	1.75
Exercisable at December 31, 2011	125,034	$22.43	1.75
Outstanding as of December 31, 2011	125,034	$22.43	1.75
Granted	—	—	
Exercised	—	—	
Expired	—	—	
Forfeited	—	—	
Outstanding at September 30, 2012	125,034	$22.43	1.00
Exercisable at September 30, 2012	125,034	$22.43	1.00

Restricted Stock

Under the Plan, the Corporation may grant restricted shares to plan participants, subject to forfeiture upon the occurrence of certain events until the dates specified in the participant’s award agreement. While the restricted shares are subject to forfeiture, the participant may exercise full voting rights and will receive all dividends and other distributions paid with respect to the restricted shares. The restricted shares granted under the Plan are subject to graded vesting. Compensation expense is recognized over the requisite service period of four years for the entire award on a straight-line basis. Upon vesting of restricted share awards, the benefit of tax deductions in excess of recognized compensation expense is recognized as a financing cash flow activity.

Restricted share activity for the year ended December 31, 2011 and the nine months ended September 30, 2012 was as follows:

	Number of Restricted Shares	Weighted Average Grant-Date Fair Value
Nonvested balance as of December 31, 2010	101,182	$14.93
Granted	34,625	17.05
Vested	(39,939)	16.24
Forfeited	—	—
Nonvested balance as of December 31, 2011	95,868	15.15
Granted	34,923	23.02
Vested	(19,221)	16.10
Forfeited	—	—
Nonvested balance as of September 30, 2012	111,570	$17.45

As of September 30, 2012, $1.7 million of deferred compensation expense was included in additional paid-in capital in the consolidated balance sheet related to unvested restricted shares which the Corporation expects to recognize over approximately 3 years. As of September 30, 2012, all restricted shares that vested were delivered. For the nine months ended September 30, 2012 and 2011, share-based compensation expense included in the consolidated statements of income totaled $403,000 and $439,000, respectively.

Note 4 — Securities

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The amortized cost and estimated fair value of securities available-for-sale were as follows:

	As of September 30, 2012			
	Amortized cost	Gross unrealized holding gains	Gross unrealized holding losses	Estimated fair value
	(In Thousands)			
U.S. Government agency obligations - government-sponsored enterprises	$16,177	$61	$(1)	$16,237
Municipal obligations	9,954	133	(31)	10,056
Collateralized mortgage obligations - government issued	159,846	4,114	(74)	163,886
Collateralized mortgage obligations - government-sponsored enterprises	12,563	74	(11)	12,626
	$198,540	$4,382	$(117)	$202,805

	As of December 31, 2011			
	Amortized cost	Gross unrealized holding gains	Gross unrealized holding losses	Estimated fair value
	(In Thousands)			
Municipal obligations	$2,736	$95	$—	$2,831
Collateralized mortgage obligations - government issued	161,443	4,022	(64)	165,401
Collateralized mortgage obligations - government-sponsored enterprises	2,169	—	(15)	2,154
	$166,348	$4,117	$(79)	$170,386

U.S. Government agency obligations - government-sponsored enterprises represent securities issued by the Federal Home Loan Mortgage Corporation ("FHLMC") and Federal National Mortgage Association ("FNMA"). Collateralized mortgage obligations - government issued represent securities guaranteed by the Government National Mortgage Association ("GNMA"). Collateralized mortgage obligations — government-sponsored enterprises include securities guaranteed by FHLMC and the FNMA. Municipal obligations include securities issued by various municipalities located primarily within the State of Wisconsin and are tax-exempt general obligation bonds. There were no sales of securities available for sale in the three and nine month periods ended September 30, 2012 and 2011.
The amortized cost and estimated fair value of securities available-for-sale by contractual maturity at September 30, 2012 are shown below. Actual maturities may differ from contractual maturities because issuers have the right to call or prepay obligations without call or prepayment penalties.

	Amortized Cost	Estimated Fair Value
	(In Thousands)	
Due in one year or less	$83	$83
Due in one year through five years	13,131	13,180
Due in five through ten years	16,474	16,764
Due in over ten years	168,852	172,778
	$198,540	$202,805

The table below shows the Corporation’s gross unrealized losses and fair value of investments, aggregated by investment category and length of time that individual investments were in a continuous unrealized loss position at September 30, 2012 and December 31, 2011. At September 30, 2012 and December 31, 2011, the Corporation had 32 securities and 9 securities that were in an unrealized loss position, respectively. Such securities have not experienced credit rating downgrades; however, they

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have primarily declined in value due to the current interest rate environment. At September 30, 2012, the Corporation held no securities that had been in a continuous loss position for twelve months or greater.

The Corporation also has not specifically identified securities in a loss position that it intends to sell in the near term and does not believe that it will be required to sell any such securities. It is expected that the Corporation will recover the entire amortized cost basis of each security based upon an evaluation of the present value of the expected future cash flows. Accordingly, no other than temporary impairment was recorded in the consolidated results of operations for the nine months ended September 30, 2012 and 2011.

A summary of unrealized loss information for available-for-sale securities, categorized by security type follows:

	As of September 30, 2012					
	Less than 12 months		12 months or longer		Total	
	Fair value	Unrealized losses	Fair value	Unrealized losses	Fair value	Unrealized losses
	(In Thousands)					
U.S. Government agency obligations - government-sponsored enterprises	$1,499	$1	$—	$—	$1,499	$1
Municipal obligations	3,601	31	—	—	3,601	31
Collateralized mortgage obligations - government issued	15,717	74	—	—	15,717	74
Collateralized mortgage obligations - government-sponsored enterprises	3,652	11	—	—	3,652	11
	$24,469	$117	$—	$—	$24,469	$117

	As of December 31, 2011					
	Less than 12 months		12 months or longer		Total	
	Fair value	Unrealized losses	Fair value	Unrealized losses	Fair value	Unrealized losses
	(In Thousands)					
Collateralized mortgage obligations - government issued	$16,336	$64	$—	$—	$16,336	$64
Collateralized mortgage obligations - government-sponsored enterprises	2,076	15	—	—	2,076	15
	$18,412	$79	$—	$—	$18,412	$79

At September 30, 2012 and December 31, 2011, securities with a fair value of $22.9 million and $19.6 million, respectively, were pledged to secure interest rate swap contracts, outstanding Federal Home Loan Bank ("FHLB") advances and client letters of credit. Securities pledged also provide for future availability for additional advances from the FHLB.

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Note 5 — Loan and Lease Receivables, Impaired Loans and Leases and Allowance for Loan and Lease Losses

Loan and lease receivables consist of the following:

	September 30, 2012	December 31, 2011
	(In Thousands)	
Commercial real estate		
Commercial real estate — owner occupied	$153,534	$150,528
Commercial real estate — non-owner occupied	295,852	304,597
Construction and land development	50,158	38,124
Multi-family	57,565	43,905
1-4 family	33,602	43,513
Total commercial real estate	590,711	580,667
Commercial and industrial	255,202	237,099
Direct financing leases, net	16,462	17,128
Consumer and other		
Home equity and second mortgages	4,670	4,970
Other	11,789	11,682
Total consumer and other	16,459	16,652
Total gross loans and leases receivable	878,834	851,546
Less:		
Allowance for loan and lease losses	14,706	14,155
Deferred loan fees	642	704
Loans and leases receivable, net	$863,486	$836,687

The total principal amount of loans transferred to third parties, which consisted solely of participation interests in originated loans, during the three months ended September 30, 2012 and 2011 was $20.1 million and $10.9 million, respectively. For the nine months ended September 30, 2012 and 2011, $54.8 million and $21.0 million of loans were transferred to third parties, respectively. Each of the transfers of these financial assets met the qualifications for sale accounting and therefore $20.1 million and $54.8 million for the three and nine months ended September 30, 2012 and $10.9 million and $21.0 million for the three and nine months ended September 30, 2011 have been derecognized in the unaudited consolidated financial statements. The Corporation has a continuing involvement in each of the agreements by way of relationship management and servicing the loans; however, there are no further obligations required of the Corporation in the event of default, other than standard representations and warranties related to sold amounts. The loans were transferred at their fair value and no gain or loss was recognized upon the transfer as the participation interest was transferred at or near the date of loan origination. There were no other significant purchases or sales of loan and lease receivables or transfers to loans held for sale during the three and nine months ended September 30, 2012 and 2011.

The total amount of outstanding loans transferred to third parties as loan participations sold at September 30, 2012 and December 31, 2011 was $44.7 million and $49.2 million, respectively, all of which were treated as a sale and derecognized under the applicable accounting guidance in effect at the time of the transfers of the financial assets. The Corporation's continuing involvement with these loans is by way of partial ownership, relationship management and all servicing responsibilities. As of September 30, 2012 and December 31, 2011, the total amount of the Corporation's partial ownership of loans on the Corporation’s balance sheet was $63.9 million and $74.6 million, respectively. As of September 30, 2012 and December 31, 2011, $3.3 million and $3.4 million of the loans in this participation sold portfolio were considered impaired, respectively. Since December 2010, the Corporation recognized a total $2.7 million charge-off associated with specific credits within the retained portion of this portfolio of loans in accordance with the Corporation’s allowance for loan and lease loss measurement process and policies. The Corporation does not share in the participant’s portion of the charge-offs. The total amount of loan participations purchased on the

Corporation's balance sheet as of September 30, 2012 and December 31, 2011 was $678,000 and $689,000, respectively.

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The following information illustrates ending balances of the Corporation's loan and lease portfolio, including impaired loans by class of receivable, and considering certain credit quality indicators as of September 30, 2012 and December 31, 2011:

As of September 30, 2012	Category I	II	III	IV	Total
	(Dollars in Thousands)				
Commercial real estate:					
Commercial real estate — owner occupied	$128,661	$6,778	$17,166	$929	$153,534
Commercial real estate — non-owner occupied	228,493	40,038	26,490	831	295,852
Construction and land development	33,845	1,485	9,089	5,739	50,158
Multi-family	49,875	6,848	793	49	57,565
1-4 family	18,331	4,510	8,074	2,687	33,602
Total commercial real estate	459,205	59,659	61,612	10,235	590,711
Commercial and industrial	231,407	7,866	14,336	1,593	255,202
Direct financing leases, net	11,933	2,862	1,667	—	16,462
Consumer and other:					
Home equity and second mortgages	3,531	167	181	791	4,670
Other	10,665	—	—	1,124	11,789
Total consumer and other	14,196	167	181	1,915	16,459
Total gross loans and leases receivable	$716,741	$70,554	$77,796	$13,743	$878,834
Category as a % of total portfolio	81.56 %	8.03 %	8.85 %	1.56 %	100.00 %

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As of December 31, 2011	Category I	II	III	IV	Total
	(Dollars in Thousands)				
Commercial real estate:					
Commercial real estate — owner occupied	$117,065	$16,488	$14,004	$2,971	$150,528
Commercial real estate — non-owner occupied	236,868	34,823	30,657	2,249	304,597
Construction and land development	20,660	5,367	4,867	7,230	38,124
Multi-family	34,162	6,930	804	2,009	43,905
1-4 family	23,266	11,637	4,993	3,617	43,513
Total commercial real estate	432,021	75,245	55,325	18,076	580,667
Commercial and industrial	198,018	25,070	12,453	1,558	237,099
Direct financing leases, net	11,398	5,026	686	18	17,128
Consumer and other:					
Home equity and second mortgages	3,524	188	256	1,002	4,970
Other	10,459	—	—	1,223	11,682
Total consumer and other	13,983	188	256	2,225	16,652
Total gross loans and leases receivable	$655,420	$105,529	$68,720	$21,877	$851,546
Category as a % of total portfolio	76.97 %	12.39 %	8.07 %	2.57 %	100.00 %

Credit underwriting through a committee process is a key component of the Corporation’s operating philosophy. Business development officers have relatively low individual lending authority limits, and thus a significant portion of the Corporation’s new credit extensions require approval from a loan approval committee regardless of the type of loan or lease, asset quality grade of the credit, amount of the credit, or the related complexities of each proposal. In addition, the Corporation makes every effort to ensure that there is appropriate collateral at the time of origination to protect the Corporation’s interest in the related loan or lease.

Each credit is evaluated for proper risk rating upon origination, at the time of each subsequent renewal, upon receipt and evaluation of updated financial information from our borrowers, or as other circumstances dictate. The Corporation uses a nine grade risk rating system to monitor the ongoing credit quality of its loans and leases. The risk rating grades follow a consistent definition, but are then applied to specific loan types based on the nature of the loan. Each risk rating is subjective and, depending on the size and nature of the credit, subject to various levels of review and concurrence on the stated risk rating. The Corporation groups loans into four loan and related risk categories which determine the level and nature of review by management.

Category I — Loans and leases in this category are performing in accordance with the terms of the contract and generally exhibit no immediate concerns regarding the security and viability of the underlying collateral, financial stability of the borrower, integrity or strength of the borrower’s management team or the industry in which the borrower operates. Loans and leases in this category are not subject to additional monitoring procedures above and beyond what is required at the origination or renewal of the loan or lease. The Corporation monitors Category I loans and leases through payment performance, continued maintenance of our personal relationships with such borrowers and continued review of such borrowers' compliance with the terms of the agreement.

Category II — Loans and leases in this category are beginning to show signs of deterioration in one or more of the Corporation’s core underwriting criteria such as financial stability, management strength, industry trends and collateral values. Management will place credits in this category to allow for proactive monitoring and resolution with the borrower to possibly mitigate the area of concern and prevent further deterioration or risk of loss to the Corporation. Category II loans are considered performing but are monitored frequently by the assigned business development officer and by a subcommittee of the Banks' loan committees.

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Category III — Loans and leases in this category are identified by the Corporation's business development officers and senior management as warranting special attention. However, the balance in this category is not intended to represent the amount of adversely classified assets held by the Banks. Category III loans and leases generally exhibit undesirable characteristics such as evidence of adverse financial trends and conditions, managerial problems, deteriorating economic conditions within the related industry, or evidence of adverse public filings and may exhibit collateral shortfall positions. Management continues to believe that it will collect all required principal and interest in accordance with the original terms of the contract, and therefore Category III loans are considered performing with no specific reserves established for this category. Category III loans are monitored on a monthly basis by management, loan committees of the Banks, and the Banks' Boards of Directors.

Category IV — Loans and leases in this category are considered to be impaired. Impaired loans and leases have been placed on non-accrual as management has determined that it is unlikely that the Banks will receive the required principal and interest in accordance with the contractual terms of the agreement. Impaired loans are individually evaluated to assess the need for the establishment of specific reserves or charge-offs. When analyzing the adequacy of collateral, the Corporation obtains external appraisals at least annually for impaired loans and leases. External appraisals are obtained from the Corporation's approved appraiser listing and are independently reviewed to monitor the quality of such appraisals. To the extent a collateral shortfall position is present, a specific reserve or charge-off will be recorded to reflect the magnitude of the impairment. Loans and leases in this category are monitored on a monthly basis by management, loan committees of the Banks, and the Banks' Boards of Directors.

Utilizing regulatory terminology, the Corporation identified $24.0 million and $3.9 million of loans and leases as Substandard and Special Mention, respectively, as of September 30, 2012. As of December 31, 2011, $42.6 million of loans were considered Substandard and no loans were considered Special Mention. No loans and leases were identified as Doubtful, or Loss at September 30, 2011 and December 31, 2010. The population of Special Mention and Substandard loans are a subset of Category III and Category IV loans.

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The delinquency aging of the loan and lease portfolio by class of receivable as of September 30, 2012 and December 31, 2011 were as follows:

As of September 30, 2012	30-59 days past due	60-89 days past due	Greater than 90 days past due	Total past due	Current	Total loans
	(Dollars in Thousands)					
Accruing loans and leases						
Commercial real estate:						
Owner occupied	$—	$—	$—	$—	$152,605	$152,605
Non-owner occupied	—	—	—	—	295,388	295,388
Construction and land development	4,025	—	—	4,025	40,924	44,949
Multi-family	—	—	—	—	57,516	57,516
1-4 family	—	—	—	—	30,915	30,915
Commercial & industrial	42	—	—	42	253,567	253,609
Direct financing leases, net	—	—	—	—	16,462	16,462
Consumer and other:						
Home equity and second mortgages	—	—	—	—	3,879	3,879
Other	—	—	—	—	10,665	10,665
Total	4,067	—	—	4,067	861,921	865,988
Non-accruing loans and leases						
Commercial real estate:						
Owner occupied	$—	$—	$117	$117	$812	$929
Non-owner occupied	—	—	464	464	—	464
Construction and land development	—	—	538	538	4,671	5,209
Multi-family	—	—	—	—	49	49
1-4 family	75	—	618	693	1,994	2,687
Commercial & industrial	—	—	208	208	1,385	1,593
Direct financing leases, net	—	—	—	—	—	—
Consumer and other:						
Home equity and second mortgages	—	—	128	128	663	791
Other	—	—	1,124	1,124	—	1,124
Total	75	—	3,197	3,272	9,574	12,846
Total loans and leases						
Commercial real estate:						
Owner occupied	$—	$—	$117	$117	$153,417	$153,534
Non-owner occupied	—	—	464	464	295,388	295,852
Construction and land development	4,025	—	538	4,563	45,595	50,158
Multi-family	—	—	—	—	57,565	57,565
1-4 family	75	—	618	693	32,909	33,602
Commercial & industrial	42	—	208	250	254,952	255,202
Direct financing leases, net	—	—	—	—	16,462	16,462
Consumer and other:						
Home equity and second mortgages	—	—	128	128	4,542	4,670
Other	—	—	1,124	1,124	10,665	11,789
Total	$4,142	$—	$3,197	$7,339	$871,495	$878,834
Percent of portfolio	0.47 %	— %	0.37 %	0.84 %	99.16 %	100.00 %

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As of December 31, 2011	30-59 days past due	60-89 days past due	Greater than 90 days past due	Total past due	Current	Total loans
	(Dollars in Thousands)					
Accruing loans and leases						
Commercial real estate:						
Owner occupied	$106	$—	$—	$106	$147,450	$147,556
Non-owner occupied	—	131	—	131	302,217	302,348
Construction and land development	3,942	—	—	3,942	26,953	30,895
Multi-family	—	—	—	—	41,896	41,896
1-4 family	—	—	—	—	40,007	40,007
Commercial & industrial	25	—	—	25	235,516	235,541
Direct financing leases, net	—	—	—	—	17,110	17,110
Consumer and other:						
Home equity and second mortgages	—	—	—	—	3,968	3,968
Other	—	—	—	—	10,459	10,459
Total	4,073	131	—	4,204	825,576	829,780
Non-accruing loans and leases						
Commercial real estate:						
Owner occupied	$—	$—	$2,011	$2,011	$961	$2,972
Non-owner occupied	—	155	1,625	1,780	469	2,249
Construction and land development	114	515	704	1,333	5,896	7,229
Multi-family	—	—	2,009	2,009	—	2,009
1-4 family	404	224	495	1,123	2,383	3,506
Commercial & industrial	21	—	298	319	1,239	1,558
Direct financing leases, net	—	—	—	—	18	18
Consumer and other:						
Home equity and second mortgages	—	40	315	355	647	1,002
Other	—	—	1,222	1,222	1	1,223
Total	539	934	8,679	10,152	11,614	21,766
Total loans and leases						
Commercial real estate:						
Owner occupied	$106	$—	$2,011	$2,117	$148,411	$150,528
Non-owner occupied	—	286	1,625	1,911	302,686	304,597
Construction and land development	4,056	515	704	5,275	32,849	38,124
Multi-family	—	—	2,009	2,009	41,896	43,905
1-4 family	404	224	495	1,123	42,390	43,513
Commercial & industrial	46	—	298	344	236,755	237,099
Direct financing leases, net	—	—	—	—	17,128	17,128
Consumer and other:						
Home equity and second mortgages	—	40	315	355	4,615	4,970
Other	—	—	1,222	1,222	10,460	11,682

Total	$4,612	$1,065	$8,679	$14,356	$837,190	$851,546
Percent of portfolio	0.54 %	0.12 %	1.02 %	1.68 %	98.32 %	100.00 %

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The Corporation's non-accrual loans and leases consisted of the following at September 30, 2012 and December 31, 2011, respectively.

	September 30, 2012	December 31, 2011
	(Dollars in Thousands)	
Non-accrual loans and leases		
Commercial real estate:		
Commercial real estate — owner occupied	$929	$2,972
Commercial real estate — non-owner occupied	464	2,249
Construction and land development	5,209	7,229
Multi-family	49	2,009
1-4 family	2,687	3,506
Total non-accrual commercial real estate	9,338	17,965
Commercial and industrial	1,593	1,558
Direct financing leases, net	—	18
Consumer and other:		
Home equity and second mortgage	791	1,002
Other	1,124	1,223
Total non-accrual consumer and other loans	1,915	2,225
Total non-accrual loans and leases	12,846	21,766
Foreclosed properties, net	2,187	2,236
Total non-performing assets	$15,033	$24,002
Performing troubled debt restructurings	$897	$111

	September 30, 2012	December 31, 2011
Total non-accrual loans and leases to gross loans and leases	1.46 %	2.56 %
Total non-performing assets to total gross loans and leases plus foreclosed properties, net	1.71	2.81
Total non-performing assets to total assets	1.26	2.04
Allowance for loan and lease losses to gross loans and leases	1.67	1.66
Allowance for loan and lease losses to non-accrual loans and leases	114.48	65.03

As of September 30, 2012 and December 31, 2011, $10.8 million and $13.3 million of the impaired loans were considered troubled debt restructurings, respectively. As of September 30, 2012, there were no unfunded commitments associated with troubled debt restructured loans and leases.

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	As of September 30, 2012			As of December 31, 2011		
	Number of Loans	Pre-Modification Recorded Investment	Post-Modification Recorded Investment	Number of Loans	Pre-Modification Recorded Investment	Post-Modification Recorded Investment
	(Dollars in Thousands)					
Troubled debt restructurings:						
Commercial real estate						
Commercial real estate — owner occupied	4	$ 338	$ 277	5	$ 380	$ 352
Commercial real estate — non-owner occupied	6	972	831	6	971	902
Construction and land development	3	8,044	4,983	4	8,457	5,692
Multi-family	1	184	49	—	—	—
1-4 family	14	2,951	2,613	15	3,152	3,031
Commercial and industrial	7	2,250	1,048	9	2,394	1,393
Direct financing leases, net	—	—	—	1	32	18
Consumer and other:						
Home equity and second mortgage	8	865	770	8	865	813
Other	1	2,076	1,124	1	2,076	1,222
Total	44	$ 17,680	$ 11,695	49	$ 18,327	$ 13,423

All loans and leases modified as a troubled debt restructuring are evaluated for impairment. The nature and extent of the impairment of restructured loans, including those which have experienced a default, is considered in the determination of an appropriate level of the allowance for loan and lease losses.

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As of September 30, 2012 and December 31, 2011, our troubled debt restructurings grouped by type of concession were as follows:

	As of September 30, 2012		As of December 31, 2011	
	Number of Loans	Recorded Investment	Number of Loans	Recorded Investment
	(Dollars in Thousands)			
Commercial real estate				
Extension of term	2	$123	2	$127
Combination of extension and interest rate concession	26	8,630	28	9,850
Commercial and industrial				
Extension of term	3	295	5	406
Combination of extension and interest rate concession	4	753	4	987
Consumer and other				
Extension of term	2	1,211	5	1,603
Combination of extension and interest rate concession	7	683	4	432
Direct financing leases, net				
Extension of term	—	—	1	18
Total	44	$11,695	49	$13,423

The following table provides the number of loans and leases modified in a troubled debt restructuring during the previous 12 months which subsequently defaulted during the nine months ended September 30, 2012, as well as the recorded investment in these restructured loans as of September 30, 2012.

	Nine months ended September 30, 2012	
	Number of Loans	Recorded Investment
	(Dollars in Thousands)	
Commercial real estate:		
Construction and land development	1	$110
1-4 family	1	223
Commercial and industrial	1	18
Consumer and other:		
Home equity and second mortgage	1	20
Total	4	$371

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The following represents additional information regarding the Corporation's impaired loans and leases by class:

Impaired Loans and Leases
As of and for the Nine Months Ended September 30, 2012

	Recorded investment	Unpaid principal balance	Impairment reserve	Average recorded investment[1]	Foregone interest income	Interest income recognized	Net foregone interest income
	(In Thousands)						
With no impairment reserve recorded:							
Commercial real estate:							
Owner occupied	$929	$929	$—	$ 1,710	$124	$2	$122
Non-owner occupied	676	676	—	1,433	174	207	(33)
Construction and land development	5,209	8,786	—	6,089	190	24	166
Multi-family	49	416	—	403	58	60	(2)
1-4 family	1,813	1,915	—	2,043	113	—	113
Commercial and industrial	862	1,031	—	1,440	80	25	55
Direct financing leases, net	—	—	—	5	—	1	(1)
Consumer and other:							
Home equity and second mortgages	668	668	—	782	44	1	43
Other	1,124	1,612	—	1,164	85	1	84
Total	11,330	16,033	—	15,069	868	321	547
With impairment reserve recorded:							
Commercial real estate:							
Owner occupied	$—	$—	$—	$ —	$—	$—	$—
Non-owner occupied	155	155	155	155	2	—	2
Construction and land development	530	530	190	541	15	—	15
Multi-family	—	—	—	—	—	—	—
1-4 family	874	875	322	892	38	—	38
Commercial and industrial	731	3,361	205	1,856	170	—	170
Direct financing leases, net	—	—	—	—	—	—	—
Consumer and other:							
Home equity and second mortgages	123	123	94	140	7	—	7
Other	—	—	—	—	—	—	—
Total	2,413	5,044	966	3,584	232	—	232
Total:							
Commercial real estate:							
Owner occupied	$929	$929	$—	$ 1,710	$124	$2	$122
Non-owner occupied	831	831	155	1,588	176	207	(31)
	5,739	9,316	190	6,630	205	24	181

Construction and land development							
Multi-family	49	416	—	403	58	60	(2)
1-4 family	2,687	2,790	322	2,935	151	—	151
Commercial and industrial	1,593	4,392	205	3,296	250	25	225
Direct financing leases, net	—	—	—	5	—	1	(1)
Consumer and other:							
Home equity and second mortgages	791	791	94	922	51	1	50
Other	1,124	1,612	—	1,164	85	1	84
Grand total	$13,743	$21,077	$966	$ 18,653	$1,100	$321	$779

(1) Average recorded investment is calculated primarily using daily average balances.

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	Impaired Loans and Leases As of and for the Year Ended December 31, 2011						
	Recorded investment	Unpaid principal balance	Impairment reserve	Average recorded investment[(1)]	Foregone interest income	Interest income recognized	Net Foregone Interest Income
	(In Thousands)						
With no impairment reserve recorded:							
Commercial real estate:							
Owner occupied	$2,455	$3,669	$—	$ 5,177	$450	$200	$250
Non-owner occupied	2,249	4,081	—	5,261	424	—	424
Construction and land development	6,383	9,927	—	7,974	350	48	302
Multi-family	2,009	2,246	—	3,075	362	—	362
1-4 family	2,628	3,016	—	3,160	277	108	169
Commercial and industrial	1,139	1,320	—	3,820	384	424	(40)
Direct financing leases, net	—	—	—	—	—	—	—
Consumer and other:							
Home equity and second mortgages	803	827	—	884	62	1	61
Other	1,222	1,682	—	1,691	138	6	132
Total	18,888	26,768	—	31,042	2,447	787	1,660
With impairment reserve recorded:							
Commercial real estate:							
Owner occupied	$517	$517	$13	$ 358	$81	$—	$81
Non-owner occupied	—	—	—	—	—	—	—
Construction and land development	846	846	130	483	48	—	48
Multi-family	—	—	34	287	—	—	—
1-4 family	989	989	337	1,017	61	—	61
Commercial and industrial	419	419	276	384	24	—	24
Direct financing leases, net	18	18	18	13	1	—	1
Consumer and other:							
Home equity and second mortgages	199	199	79	208	20	—	20
Other	1	1	1	1	—	—	—
Total	2,989	2,989	888	2,751	235	—	235
Total:							
Commercial real estate:							
Owner occupied	$2,972	$4,186	$13	$ 5,535	$531	$200	$331
Non-owner occupied	2,249	4,081	—	5,261	424	—	424
Construction and land development	7,229	10,773	130	8,457	398	48	350

Multi-family	2,009	2,246	34	3,362	362	—	362
1-4 family	3,617	4,005	337	4,177	338	108	230
Commercial and industrial	1,558	1,739	276	4,204	408	424	(16)
Direct financing leases, net	18	18	18	13	1	—	1
Consumer and other:							
Home equity and second mortgages	1,002	1,026	79	1,092	82	1	81
Other	1,223	1,683	1	1,692	138	6	132
Grand total	$21,877	$29,757	$888	$ 33,793	$2,682	$787	$1,895

(1) Average recorded investment is calculated primarily using daily average balances.

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The difference between the loans and leases recorded investment and the unpaid principal balance of $7.3 million and $7.9 million as of September 30, 2012 and December 31, 2011 represents partial charge-offs resulting from confirmed losses due to the value of the collateral securing the loans and leases being below the carrying values of the loans and leases. Impaired loans and leases also included $897,000 and $111,000 of loans that were performing troubled debt restructurings, and thus, while not on non-accrual, were reported as impaired, due to the concession in terms. When a loan is placed on non-accrual, interest accruals are discontinued and previously accrued but uncollected interest is deducted from interest income. Cash payments collected on non-accrual loans are first applied to principal. Foregone interest represents the interest that was contractually due on the note but not received or recorded. To the extent the amount of principal on a non-accrual note is fully collected and additional cash is received, the Corporation will recognize interest income.

To determine the level and composition of the allowance for loan and lease losses, the Corporation breaks out the portfolio by segments and risk ratings. First, the Corporation evaluates loans and leases for potential impairment classification. The Corporation analyzes each loan and lease determined to be impaired on an individual basis to determine a specific reserve based upon the estimated value of the underlying collateral for collateral-dependent loans, or alternatively, the present value of expected cash flows. The Corporation applies historical trends from established risk factors to each category of loans and leases that has not been individually evaluated for the purpose of establishing the general portion of the allowance.

A summary of the activity in the allowance for loan and lease losses by portfolio segment is as follows:

	As of and for the Nine Months Ended September 30, 2012				
	Commercial real estate	Commercial and industrial	Consumer and other	Direct financing leases, net	Total
	(Dollars in Thousands)				
Allowance for credit losses:					
Beginning balance	$9,554	$3,977	$384	$240	$14,155
Charge-offs	(467)	(2,668)	(107)	—	(3,242)
Recoveries	291	65	38	—	394
Provision	572	2,764	83	(20)	3,399
Ending balance	$9,950	$4,138	$398	$220	$14,706
Ending balance: individually evaluated for impairment	$667	$205	$94	$—	$966
Ending balance: collectively evaluated for impairment	$9,283	$3,933	$304	$220	$13,740
Ending balance: loans acquired with deteriorated credit quality	$—	$—	$—	$—	$—
Loans and lease receivables:					
Ending balance, gross	$590,711	$255,202	$16,459	$16,462	$878,834
Ending balance: individually evaluated for impairment	$10,235	$1,593	$1,915	$—	$13,743
Ending balance: collectively evaluated for impairment	$580,476	$253,609	$14,544	$16,462	$865,091
Ending balance: loans acquired with deteriorated credit quality	$—	$—	$—	$—	$—
Allowance as % of gross loans	1.68 %	1.62 %	2.42 %	1.34 %	1.67 %

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	As of and for the Nine Months Ended September 30, 2011				
	Commercial real estate	Commercial and industrial	Consumer and other	Direct financing leases, net	Total
	(Dollars in Thousands)				
Allowance for credit losses:					
Beginning balance	$11,267	$4,277	$482	$245	$16,271
Charge-offs	(5,444)	(471)	(325)	—	(6,240)
Recoveries	277	432	69	19	797
Provision	3,488	(338)	187	(24)	3,313
Ending balance	$9,588	$3,900	$413	$240	$14,141
Ending balance: individually evaluated for impairment	$757	$252	$82	$25	$1,116
Ending balance: collectively evaluated for impairment	$8,831	$3,648	$331	$215	$13,025
Ending balance: loans acquired with deteriorated credit quality	$—	$—	$—	$—	$—
Loans and lease receivables:					
Ending balance, gross	$602,869	$224,257	$18,012	$16,324	$861,462
Ending balance: individually evaluated for impairment	$22,900	$1,714	$2,490	$25	$27,129
Ending balance: collectively evaluated for impairment	$579,969	$222,543	$15,522	$16,299	$834,333
Ending balance: loans acquired with deteriorated credit quality	$—	$—	$—	$—	$—
Allowance as % of gross loans	1.59%	1.74%	2.29%	1.47%	1.64%

Note 6 — Deposits

Deposits consisted of the following:

	September 30, 2012			December 31, 2011		
	Balance	Weighted average balance	Weighted average rate	Balance	Weighted average balance	Weighted average rate
	(Dollars in Thousands)					
Non-interest-bearing transaction accounts	$140,831	$131,761	—%	$132,230	$112,899	—%
Interest-bearing transaction accounts	38,099	34,263	0.30	23,004	25,389	0.28
Money market accounts	409,823	384,488	0.81	364,082	300,652	0.99
Certificates of deposit	81,777	84,907	1.20	85,331	80,323	1.38
Brokered certificates of deposit	390,728	409,393	2.28	446,665	486,594	2.66
Total deposits	$1,061,258	$1,044,812	1.29	$1,051,312	$1,005,857	1.70

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Note 7 — FHLB Advances, Other Borrowings and Junior Subordinated Notes Payable

The composition of borrowed funds at September 30, 2012 and December 31, 2011 was as follows:

	September 30, 2012			December 31, 2011		
	Balance	Weighted average balance	Weighted average rate	Balance	Weighted average balance	Weighted average rate
	(Dollars in Thousands)					
Federal funds purchased	$—	$148	0.81 %	$—	$252	0.90 %
FHLB advances	472	2,520	1.32	482	656	5.83
Line of credit	10	2,223	4.04	810	2,236	4.06
Subordinated notes payable	39,000	39,000	6.99	39,000	39,000	6.12
Junior subordinated notes	10,315	10,315	10.79	10,315	10,315	10.78
	$49,797	$54,206	7.33	$50,607	$52,459	6.94
Short-term borrowings	$482			$810		
Long-term borrowings	49,315			49,797		
	$49,797			$50,607		

As of September 30, 2012, the Corporation was in compliance with its debt covenants under its senior line of credit. The Corporation pays an unused line fee on its secured senior line of credit. For the nine months ended September 30, 2012 and 2011, the Corporation incurred unused line fee expense of $8,000 and $7,000, respectively. The unused line fee is recorded as a component of interest expense.

During the first quarter of 2012, the Corporation sold and issued approximately $6.2 million in aggregate principal amount of subordinated debentures to certain accredited investors. The debentures have been structured to qualify as Tier 2 capital, mature on January 15, 2022 and bear a fixed interest rate of 7.5% per year for their entire term. The Corporation may, at its option, redeem the debentures, in whole or part, at any time after the fifth anniversary of issuance. The Corporation used the net proceeds from the sale of the debentures to replace a portion of its existing $39.0 million of subordinated notes payable to diversify its sources of debt, obtain a longer term fixed rate instrument and enhance its regulatory capital position.

Note 8 — Fair Value Disclosures

The Corporation determines the fair market values of its financial instruments based on the fair value hierarchy established in ASC Topic 820, which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. Fair value is defined as the price that would be received in an orderly transaction that is not a forced liquidation or distressed sale at the measurement date and is based on exit prices. Fair value includes assumptions about risk such as nonperformance risk in liability fair values and is a market-based measurement, not an entity-specific measurement. The standard describes three levels of inputs that may be used to measure fair value.

Level 1 — Level 1 inputs are unadjusted quoted prices in active markets for identical assets or liabilities that the Corporation has the ability to access at the measurement date.

Level 2 — Level 2 inputs are inputs other than quoted prices included with Level 1 that are observable for the asset or liability either directly or indirectly, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 3 — Level 3 inputs are inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

In instances where the determination of the fair value measurement is based on inputs from different levels of the fair value hierarchy, the level in the fair value hierarchy within which the entire fair value measurement falls is based on the lowest level input that is significant to the fair value measurement in its entirety. The Corporation's assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment and considers factors specific to the asset or liability.

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Assets and liabilities measured at fair value on a recurring basis, segregated by fair value hierarchy level, are summarized below:

	Fair Value Measurements Using			
September 30, 2012	Level 1	Level 2	Level 3	Total
	(In Thousands)			
Assets:				
Municipal obligations	$—	$10,056	$—	$10,056
U.S. Government agency obligations - government-sponsored enterprises	—	16,237	—	16,237
Collateralized mortgage obligations - government issued	—	163,886	—	163,886
Collateralized mortgage obligations - government-sponsored enterprises				