First Business Financial Services, Inc.
Form 10-Q
April 29, 2011

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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 March 31, 2011
OR

o **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 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
Telephone number

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities 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 o

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 o No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. 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 o	Accelerated filer o	Non-accelerated filer o (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 o No þ

The number of shares outstanding of the registrant s sole class of common stock, par value $0.01 per share, on April 20, 2011 was 2,597,444 shares.

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PART I. Financial Information

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

	(Unaudited) March 31, 2011	December 31, 2010
	(In Thousands, Except Share Data)	
Assets		
Cash and due from banks	$ 8,761	$ 9,450
Short-term investments	51,571	41,369
Cash and cash equivalents	60,332	50,819
Securities available-for-sale, at fair value	159,793	153,379
Loans and leases receivable, net of allowance for loan and lease losses of $16,802 and $16,271, respectively	851,104	860,935
Leasehold improvements and equipment, net	951	974
Foreclosed properties	2,327	1,750
Cash surrender value of bank-owned life insurance	17,125	16,950
Investment in Federal Home Loan Bank stock, at cost	2,367	2,367
Accrued interest receivable and other assets	18,866	19,883
Total assets	$ 1,112,865	$ 1,107,057
Liabilities and Stockholders Equity		
Deposits	$ 996,080	$ 988,298
Federal Home Loan Bank and other borrowings	39,501	41,504
Junior subordinated notes	10,315	10,315
Accrued interest payable and other liabilities	10,652	11,605
Total liabilities	1,056,548	1,051,722
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, 2,680,360 shares issued, 2,597,538 and 2,597,820 shares outstanding at 2011 and 2010, respectively	27	27
Additional paid-in capital	25,408	25,253
Retained earnings	30,975	29,808
Accumulated other comprehensive income	1,455	1,792
Treasury stock (82,822 and 82,540 shares at 2011 and 2010, respectively), at cost	(1,548)	(1,545)

Total stockholders equity	56,317	55,335
Total liabilities and stockholders equity	$ 1,112,865	$ 1,107,057

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 March 31,	
	2011	2010
	(In Thousands, Except Share Data)	
Interest income:		
Loans and leases	$ 12,920	$ 13,190
Securities income, taxable	1,117	1,135
Short-term investments	33	41
Total interest income	14,070	14,366
Interest expense:		
Deposits	4,650	5,511
Notes payable and other borrowings	662	734
Junior subordinated notes	274	274
Total interest expense	5,586	6,519
Net interest income	8,484	7,847
Provision for loan and lease losses	1,404	1,344
Net interest income after provision for loan and lease losses	7,080	6,503
Non-interest income:		
Trust and investment services fee income	641	567
Service charges on deposits	373	398
Loan fees	331	291
Increase in cash surrender value of bank-owned life insurance	167	161
Credit, merchant and debit card fees	52	51
Other	108	161
Total non-interest income	1,672	1,629
Non-interest expense:		
Compensation	3,737	3,495
Occupancy	341	372
Professional fees	427	519
Data processing	310	299
Marketing	279	195
Equipment	114	145
FDIC insurance	759	782

Collateral liquidation costs		242		224
Loss on foreclosed properties		51		113
Other		500		400
Total non-interest expense		6,760		6,544
Income before income tax expense		1,992		1,588
Income tax expense		643		689
Net income	$	1,349	$	899
Earnings per share:				
Basic	$	0.52	$	0.35
Diluted		0.52		0.35
Dividends declared per share		0.07		0.07

See accompanying Notes to Unaudited Consolidated Financial Statements.

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First Business Financial Services, Inc.
Consolidated Statements of Changes in Stockholders Equity and Comprehensive Income (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, 2009	$ 26	$ 24,731	$ 29,582	$ 1,544	$ (1,490)	$ 54,393
Comprehensive income:						
Net income			899			899
Unrealized securities gains arising during the period				423		423
Income tax effect				(171)		(171)
Comprehensive income						1,151
Share-based compensation restricted shares		136				136
Cash dividends ($0.07 per share)			(179)			(179)
Treasury stock purchased (1,165 shares)					(11)	(11)
Balance at March 31, 2010	$ 26	$ 24,867	$ 30,302	$ 1,796	$ (1,501)	$ 55,490

Consolidated Statements of Changes in Stockholders Equity and Comprehensive Income

	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
Comprehensive income:						
Net income			1,349			1,349
Unrealized securities losses arising during the period				(537)		(537)
Income tax effect				200		200
Comprehensive income						1,012
Share-based compensation restricted shares		155				155
Cash dividends ($0.07 per share)			(182)			(182)
Treasury stock purchased (282 shares)					(3)	(3)

Balance at March 31, 2011	$	27	$	25,408	$	30,975	$	1,455	$	(1,548)	$ 56,317

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 Three Months Ended March 31, 2011	2010
	(In Thousands)	
Operating activities		
Net income	$ 1,349	$ 899
Adjustments to reconcile net income to net cash provided by operating activities:		
Deferred income taxes, net	(45)	(1,052)
Provision for loan and lease losses	1,404	1,344
Depreciation, amortization and accretion, net	463	318
Share-based compensation	155	136
Increase in cash surrender value of bank-owned life insurance	(167)	(161)
Origination of loans for sale	(811)	(250)
Sale of loans originated for sale	814	250
Gain on sale of loans originated for sale	(3)	
Loss on foreclosed properties	51	113
Decrease (increase) in accrued interest receivable and other assets	1,492	(175)
(Decrease) increase in accrued interest payable and other liabilities	(969)	3,078
Net cash provided by operating activities	3,733	4,500
Investing activities		
Proceeds from maturities of available-for-sale securities	10,914	9,492
Purchases of available-for-sale securities	(18,243)	(18,842)
Proceeds from sale of foreclosed properties	307	368
Net decrease (increase) in loans and leases	7,492	(1,062)
Investment in Aldine Capital Fund, L.P.	(210)	
Purchases of leasehold improvements and equipment, net	(66)	(58)
Premium payment on bank owned life insurance policies	(8)	(8)
Net cash provided by (used in) investing activities	186	(10,110)
Financing activities		
Net increase (decrease) in deposits	7,782	(19,827)
Repayment of FHLB advances	(2,003)	(2)
Cash dividends paid	(182)	(179)
Purchase of treasury stock	(3)	(11)
Net cash provided by (used in) financing activities	5,594	(20,019)
Net increase (decrease) in cash and cash equivalents	9,513	(25,629)
Cash and cash equivalents at the beginning of the period	50,819	112,737

Cash and cash equivalents at the end of the period	$ 60,332	$ 87,108
Supplementary cash flow information		
Interest paid on deposits and borrowings	$ 5,360	$ 5,960
Income taxes paid	890	33
Transfer to foreclosed properties	935	143

See accompanying Notes to Unaudited Consolidated Financial Statements.

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Notes to Unaudited Consolidated Financial Statements

Note 1 Principles of Consolidation

The unaudited consolidated financial statements include the accounts and results of First Business Financial Services, Inc. (FBFS or the Corporation), and its wholly-owned subsidiaries, First Business Bank and First Business Bank Milwaukee (Banks). 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 have been eliminated in consolidation.

Note 2 Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) and with the instructions to Form 10-Q and Rule 10-01 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, 2010 except as described below in Note 3.

In the opinion of management, all adjustments (consisting of normal recurring accruals) necessary for a fair presentation of the unaudited consolidated financial statements have been included in the unaudited consolidated financial statements. The results of operations for the three month period ended March 31, 2011 are not necessarily indicative of results that may be expected for any other interim period or the entire fiscal year ending December 31, 2011. Certain amounts in prior periods have been reclassified to conform to the current presentation. Subsequent events have been evaluated through the issuance of the unaudited consolidated financial statements.

Note 3 Recent Accounting Pronouncements

Allowance for Credit Losses. In July 2010, the FASB issued ASU 2010-20, Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses . This new accounting guidance requires additional disclosures in the notes to the consolidated financial statements regarding the nature of credit risk inherent in the loan and lease portfolio, how the credit risk is analyzed and assessed in arriving at the allowance for credit losses and the changes in the loan portfolio and the allowance for credit losses. For the Corporation, period end disclosures were required as of December 31, 2010 and disclosures about activity that occurs during the period became effective for interim and annual reporting periods beginning on or after December 15, 2010. Refer to **Note 7 Loan Lease Receivables, Impaired Loans, and Allowance for Loan and Lease Losses** for further information.

Troubled Debt Restructuring. In April 2011, the FASB issued ASU 2011-02, A Creditor s Determination of Whether a Restructuring Is a Troubled Debt Restructuring . This accounting guidance provides for clarification and guidance for evaluating whether a restructuring constitutes a troubled debt restructuring. The guidance specifically states that a creditor must separately conclude that both of the following conditions exist for a restructuring to constitute a troubled debt restructuring: 1) the restructuring constitutes a concession and 2) the debtor is experiencing financial difficulties. The amendments in this ASU are effective for the first interim or annual period beginning on or after June 15, 2011 and should be applied retrospectively to restructurings occurring on or after the beginning of the fiscal year of adoption. The impact on the allowance for loan and lease losses as a result of the identification of additional troubled debt restructurings, if any, is to be applied prospectively for the first interim or annual period beginning on or after June 15, 2011. The Corporation is currently evaluating the financial impact on the consolidated financial condition and results of operations.

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Note 4 Earnings Per 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 March 31, 2011 and 2010, average anti-dilutive employee share-based awards totaled 202,741 and 200,332, respectively.

	For the Three Months Ended March 31, 2011	2010
Distributed earnings allocated to common stockholders	$ 174,849	$ 173,177
Undistributed earnings allocated to common stockholders	1,122,814	702,253
Income available to common stockholders for basic earnings per share	1,297,663	875,430
Reallocation of undistributed earnings for diluted earnings per share		
Income available to common stockholders for diluted earnings per share	$ 1,297,663	$ 875,430
Basic average shares	2,497,918	2,473,557
Dilutive effect of share-based awards		
Dilutive average shares	2,497,918	2,473,557
Earnings per common share:		
Basic	$ 0.52	$ 0.35
Diluted	0.52	0.35

Note 5 Share-Based Compensation

The Corporation adopted an equity incentive plan in 2001 and the 2006 Equity Incentive Plan (the Plans). The Plans are administered by the Compensation Committee of the Board of Directors of FBFS and provide for the grant of equity ownership opportunities through incentive stock options and nonqualified stock options (Stock Options) as well as restricted stock. As of March 31, 2011, 74,507 shares are available for future grants under the 2006 Equity Incentive Plan. Shares covered by awards that expire, terminate or lapse will again be available for the grant of awards under the 2001 and 2006 Plans. The Corporation may issue new shares and shares from treasury for shares delivered under the Plans. The 2001 Plan expired February 16, 2011. The 2006 plan expires January 30, 2016.

Stock Options

The Corporation may grant Stock Options to senior executives and other employees under the Plans. 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 2001 and 2006 Plans are subject to graded vesting, generally ranging from four to eight 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 have been granted since the Corporation met the definition of a public entity and no Stock Options have been modified, repurchased or cancelled. Therefore, no stock-based compensation related to Stock Options was recognized in the consolidated financial statements for the three months ended March 31, 2011 and 2010. As of March 31, 2011, all Stock Options granted and not previously forfeited have vested.

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Stock Option activity for the year ended December 31, 2010 and three months ended March 31, 2011 was as follows:

	Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (Years)
Outstanding at December 31, 2009	142,790	$ 22.01	3.66
Granted			
Exercised			
Expired	(4,024)	19.38	
Forfeited			
Outstanding at December 31, 2010	138,766	22.09	2.75
Exercisable at December 31, 2010	138,766		2.75
Outstanding as of December 31, 2010	138,766	$ 22.09	2.75
Granted			
Exercised			
Expired			
Forfeited			
Outstanding at March 31, 2011	138,766	$ 22.09	2.50
Exercisable at March 31, 2011	138,766	$ 22.09	2.50

Restricted Shares

Under the Plans, 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 Plans 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 benefits of tax deductions in excess of recognized compensation expense is recognized as a financing cash flow activity. For the three months ended March 31, 2011, there was one restricted share award that vested on a date at which the market price was greater than the market value on the date of grant; however, the excess tax benefit was less than $1,000. For the three months ended March 31, 2010, all restricted share awards vested on a date at which the market price was lower than the market value on the date of grant; therefore no excess tax benefit is reflected in the unaudited consolidated statement of cash flows for that period.

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Restricted share activity for the year ended December 31, 2010 and the three months ended March 31, 2011 was as follows:

	Number of Restricted Shares		Weighted Average Grant-Date Fair Value
Nonvested balance as of December 31, 2009	70,262	$	17.88
Granted	64,725		13.97
Vested	(33,430)		19.28
Forfeited	(375)		14.55
Nonvested balance as of December 31, 2010	101,182	$	14.93
Granted			
Vested	(2,378)		18.15
Forfeited			
Nonvested balance as of March 31, 2011	98,804	$	14.85

As of March 31, 2011, $1.1 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 three years. As of March 31, 2011, all restricted shares that vested were delivered. For the three months ended March 31, 2011 and 2010, share-based compensation expense included in the consolidated statements of income totaled $155,000 and $136,000, respectively.

Note 6 Securities

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

	As of March 31, 2011							
		Amortized cost		Gross unrealized holding gains		Gross unrealized holding losses		Estimated fair value
	(In Thousands)							
Collateralized mortgage obligations government agencies	$	157,073	$	2,810	$	(514)	$	159,369
Collateralized mortgage obligations government-sponsored enterprises		417		7				424
	$	157,490	$	2,817	$	(514)	$	159,793

	As of December 31, 2010							
		Amortized cost		Gross unrealized holding gains		Gross unrealized holding losses		Estimated fair value
	(In Thousands)							
	$	149,948	$	3,255	$	(427)	$	152,776

Collateralized mortgage obligations government agencies								
Collateralized mortgage obligations government-sponsored enterprises		591		12				603
	$	150,539	$	3,267	$	(427)	$	153,379

Collateralized mortgage obligations government agencies represent securities guaranteed by the Government National Mortgage Association. Collateralized mortgage obligations government-sponsored enterprises include securities guaranteed by the Federal Home Loan Mortgage Corporation and the Federal National Mortgage Association.

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The amortized cost and estimated fair value of securities available-for-sale by contractual maturity at March 31, 2011 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	$	$
Due in one year through five years	526	546
Due in five through ten years	1,802	1,855
Due in over ten years	155,162	157,392
	$ 157,490	$ 159,793

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 have been in a continuous unrealized loss position at March 31, 2011 and December 31, 2010. At March 31, 2011 and December 31, 2010, the Corporation had 24 out of 132 securities and 17 out of 133 securities that were in an unrealized loss position, respectively. Such securities have not experienced credit rating downgrades however; they have declined in value due to the current interest rate environment. At March 31, 2011, the Corporation did not hold any 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 three months ended March 31, 2011 and 2010.
A summary of unrealized loss information for available-for-sale securities, categorized by security type follows:

	As of March 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 agencies	$ 47,612	$ 514	$	$	$ 47,612	$ 514
	$ 47,612	$ 514	$	$	$ 47,612	$ 514

	As of December 31, 2010					
	Less than 12 months		12 months or longer		Total	
	Fair value	Unrealized losses	Fair value	Unrealized losses	Fair value	Unrealized losses
	(In Thousands)					
	$ 31,862	$ 427	$	$	$ 31,862	$ 427

Collateralized mortgage obligations government issued	$ 31,862	$ 427	$	$	$ 31,862	$ 427

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There were no sales of securities available for sale in the three month periods ended March 31, 2011 and 2010.
At March 31, 2011 and December 31, 2010, securities with a fair value of $27.4 million and $30.8 million, respectively, were pledged to secure public deposits, interest rate swap contracts and outstanding Federal Home Loan Bank (FHLB) advances. Securities pledged also provide for future availability for additional advances from the FHLB.

Note 7 Loan and Lease Receivables, Impaired Loans and Leases and Allowance for Loan and Lease Losses

Loan and lease receivables consist of the following:

	March 31, 2011	December 31, 2010
	(In Thousands)	
Commercial real estate loans		
Commercial real estate owner occupied	$ 154,775	$ 152,560
Commercial real estate non-owner occupied	308,917	307,307
Construction and land development	60,229	61,645
Multi-family	44,001	43,012
1-4 family	51,099	53,849
Total commercial real estate loans	619,021	618,373
Commercial and industrial loans	212,780	225,921
Direct financing leases, net	17,516	19,288
Consumer and other		
Home equity loans and second mortgage loans	5,690	5,091
Consumer and other	13,679	9,315
	19,369	14,406
Total gross loans and lease receivables	868,686	877,988
Less:		
Allowance for loan and lease losses	16,802	16,271
Deferred loan fees	780	782
Loans and lease receivables, net	$ 851,104	$ 860,935

The total principal amount of loans transferred to third parties, which consisted solely of participation interests in originated loans, during the three months ended March 31, 2011 and 2010 was $1.5 million and $3.1 million, respectively. Each of the transfers of these financial assets met the qualifications for sale accounting and therefore $1.8 million for the three months ended March 31, 2011 and the $3.1 million for the three months ended March 31, 2010 has 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 months ended March 31, 2011 and 2010.

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The total amount of outstanding loans transferred to third parties as loan participations at March 31, 2011 and December 31, 2010 was $61.3 million and $56.0 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 continues to have involvement with these loans by way of the relationship management and all servicing responsibilities. As of March 31, 2011 and December 31, 2010, $3.5 million and $3.6 million of the loans in this participation sold portfolio were considered impaired, respectively, and in 2010, the Corporation recognized a $1.4 million charge-off associated with specific credits within the retained portion of this portfolio of loans and is measured by 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 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 March 31, 2011 and December 31, 2010:

	Category				
As of March 31, 2011	I	II	III	IV	Total
	(Dollars in Thousands)				
Commercial real estate:					
Commercial real estate owner occupied	$ 118,584	$ 16,262	$ 13,175	$ 6,754	$ 154,775
Commercial real estate non-owner occupied	225,890	45,042	32,682	5,303	308,917
Construction and land development	34,891	6,788	9,051	9,499	60,229
Multi-family	32,543	6,090	815	4,553	44,001
1-4 family	28,270	13,094	5,145	4,591	51,100
Commercial and industrial	165,896	28,199	13,121	5,564	212,780
Direct financing leases, net	11,162	6,057	297		17,516
Consumer and other:					
Home equity and second mortgages	4,094	75	460	1,060	5,689
Other	11,663	150		1,866	13,679
Total portfolio	$ 632,993	$ 121,757	$ 74,746	$ 39,190	$ 868,686
Rating as a % of total portfolio	72.87%	14.02%	8.60%	4.51%	100.00%

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As of December 31, 2010	Category I	II	III	IV	Total
	(Dollars in Thousands)				
Commercial real estate:					
Commercial real estate owner occupied	$ 113,002	$ 25,777	$ 6,780	$ 7,001	$ 152,560
Commercial real estate non-owner occupied	232,868	36,128	33,167	5,144	307,307
Construction and land development	39,662	7,838	4,870	9,275	61,645
Multi-family	31,472	6,049	1,305	4,186	43,012
1-4 family	33,310	11,973	4,329	4,237	53,849
Commercial and industrial	183,051	24,460	11,974	6,436	225,921
Direct financing leases, net	12,666	6,403	219		19,288
Consumer and other:					
Home equity and second mortgages	3,726	134	292	939	5,091
Other	7,359	50		1,906	9,315
Total portfolio	$ 657,116	$ 118,812	$ 62,936	$ 39,124	$ 877,988
Rating as a % of total portfolio	74.84%	13.53%	7.17%	4.46%	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, therefore requiring that a significant portion of the Corporation s new credit extensions be approved through various committees depending on the type of loan or lease, amount of the credit, and 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.

Upon origination, subsequent renewals, evaluation of updated financial information from our borrowers, or as other circumstances dictate, each credit is evaluated for proper risk rating. 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. Depending on the type of loan and related risk rating, the Corporation groups loans into four 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 of the debt, financial stability of the borrower, integrity or strength of the borrower s management team or the business 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 of the loan or lease. The Corporation monitors Category I loans and leases through payment performance along with personal relationships with our borrowers and monitoring of financial results or other documents or procedures required per 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 monitored frequently by the assigned business development officer and by a subcommittee of the Banks loan committees and are considered performing.

Category III Loans and leases in this category may be classified by the Banks regulatory examiners or identified by the Corporation s business development officers and senior management as warranting special attention. 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 and no specific reserves are established for this category. Management, loan committees of the Banks, as well as by the Banks Board of Directors monitor loans and leases in the category on a monthly basis.

Category IV Management considers loans and leases in this category 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 contract. 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. Management, loan committees of the Banks, as well as the Banks Board of Directors monitor loans and leases in this category on a monthly basis.

The delinquency aging of the loan and lease portfolio by class of receivable as of March 31, 2011 and December 31, 2010 were as follows:

As of March 31, 2011	30-59 days past due[1]	60-89 days past due[2]	Greater than 90 days past due[3]	Total past due	Current[4]	Total loans
			(Dollars In Thousands)			
Commercial Real Estate:						
Owner occupied	$ 942	$	$ 2,923	$ 3,865	$ 150,910	$ 154,775
Non-owner occupied			2,214	2,214	306,703	308,917
Construction and land development	249		1,729	1,978	58,251	60,229
Multi-family	1,185	485	993	2,663	41,338	44,001
1-4 family	230		1,113	1,343	49,757	51,100
Commercial & Industrial	6,045	493	695	7,233	205,547	212,780
Direct financing leases, net		117		117	17,399	17,516
Consumer and other:						
Home equity and second mortgages	70		345	415	5,274	5,689
Other	64		1,815	1,879	11,800	13,679
Total	$ 8,785 (5)	$ 1,095	$ 11,827	$ 21,707	$ 846,979	$ 868,686
Percent of portfolio	1.01%	0.13%	1.36%	2.50%	97.50%	100.00%

(1) As of March 31, 2011, $2.4 million of loans and leases in this category were considered impaired.

(2) As of March 31, 2011, $978,000 of loans and lease in this category were considered impaired.

(3) As of March 31, 2011, all of the loans in this category were considered impaired.

(4) As of March 31, 2011, $24.0 million of the loans and leases in this category were considered impaired.

(5) Approximately $5.9 million of this past due balance was associated with one borrower. This credit was specifically evaluated and not considered impaired as of March 31, 2011.

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As of December 31, 2010	30-59 days past due(1)	60-89 days past due(2)	Greater than 90 days past due(3)	Total past due	Current(4)	Total loans
			(Dollars In Thousands)			
Commercial Real Estate:						
Owner occupied	$	$	$ 2,949	$ 2,949	$ 149,611	$ 152,560
Non-owner occupied		448	2,222	2,670	304,637	307,307
Construction and land development	850	421	1,136	2,407	59,238	61,645
Multi-family			1,041	1,041	41,971	43,012
1-4 family	678		1,900	2,578	51,271	53,849
Commercial & Industrial	180	1,304	1,702	3,186	222,735	225,921
Direct financing leases, net					19,288	19,288
Consumer and other:						
Home equity and second mortgages			257	257	4,834	5,091
Other	4		1,857	1,861	7,454	9,315
Total	$ 1,712	$ 2,173	$ 13,064	$ 16,949	$ 861,039	$ 877,988
Percent of portfolio	0.19%	0.25%	1.49%	1.93%	98.07%	100.00%

(1) As of December 31, 2010, $1.0 million of loans and leases in this category were considered impaired.

(2) As of December 31, 2010, $1.7 million of loans and lease in this category were considered impaired.

(3) As of December 31, 2010, all of the loans in this category were considered impaired.

(4) As of December 31, 2010, $23.3 million of the loans and leases in this category were considered impaired.

As of March 31, 2011 and December 31, 2010, there were no loans that were greater than 90 days past due and still accruing interest.

The Corporation s non-accrual loans and leases consisted of the following at March 31, 2011 and December 31, 2010, respectively.

	March 31, 2011	December 31, 2010
	(Dollars In Thousands)	
Non-accrual loans and leases		
Commercial real estate:		
Commercial real estate owner occupied	$ 6,754	$ 6,283
Commercial real estate non-owner occupied	5,303	5,144
Construction and land development	9,499	9,275
Multi-family	4,553	4,186
1-4 family	4,591	4,237

Total non-accrual commercial real estate	30,700	29,125
Commercial and industrial	5,564	6,436
Direct financing leases, net		
Consumer and other:		
Home equity and second mortgage	1,060	939
Other	1,866	1,906
Total non-accrual consumer and other loans	2,926	2,845
Total non-accrual loans and leases	39,190	38,406
Foreclosed properties, net	2,327	1,750
Total non-performing assets	$ 41,517	$ 40,156
Performing troubled debt restructurings	$	$ 718

	March 31, 2011	December 31, 2010
Total non-accrual loans and leases to gross loans and leases	4.51%	4.37%
Total non-performing assets to total assets	3.73	3.63
Allowance for loan and lease losses to gross loans and leases	1.93	1.85
Allowance for loan and lease losses to non-accrual loans and leases	42.87	42.37

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As of March 31, 2011 and December 31, 2010, $18.1 million and $18.7 million of the impaired loans were considered troubled debt restructurings, respectively. As of March 31, 2011, there were no unfunded commitments associated with troubled debt restructured loans and leases.

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

Impaired Loans and Leases
As of and for the Three Months Ended March 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	$ 5,686	$ 6,056	$	$ 5,098	$ 111	$ 86	$ 25
Non-owner occupied	501	501		334	8		8
Construction and land development	2,783	3,809		2,115	73		73
Multi-family	1,670	2,226		1,231	41		41
1-4 family	3,573	3,761		3,186	78		78
Commercial and industrial	3,115	4,033		3,782	106	38	68
Direct financing leases, net							
Consumer and other:							
Home equity loans and second mortgages	565	565		588	12		12
Other	1,859	2,099		1,886	37		37
Total	19,752	23,050		18,220	466	124	342
With impairment reserve recorded:							
Commercial real estate:							
Owner occupied	$ 1,068	$ 1,068	$ 63	$ 1,552	$ 23	$	$ 23
Non-owner occupied	4,802	4,802	1,546	4,763	72		72
Construction and land development	6,716	8,137	295	6,956	51		51
Multi-family	2,883	3,711	529	2,912	82		82
1-4 family	1,018	1,018	334	1,041	15		15
Commercial and industrial	2,449	2,449	919	2,087	39		39
Direct financing leases, net							
Consumer and other:							
Home equity loans and second mortgages	495	495	85	475	8		8
Other	7	7	7	8			

Total	19,438	21,687	3,778	19,794	290		290
Total:							
Commercial real estate:							
Owner occupied	$ 6,754	$ 7,124	$ 63	$ 6,650	$ 134	$ 86	$ 48
Non-owner occupied	5,303	5,303	1,546	5,097	80		80
Construction and land development	9,499	11,946	295	9,071	124		124
Multi-family	4,553	5,937	529	4,143	123		123
1-4 family	4,591	4,779	334	4,227	93		93
Commercial and industrial	5,564	6,482	919	5,869	145	38	107
Direct financing leases, net							
Consumer and other:							
Home equity loans and second mortgages	1,060	1,060	85	1,063	20		20
Other	1,866	2,106	7	1,894	37		37
Grand total	$ 39,190	$ 44,737	$ 3,778	$ 38,014	$ 756	$ 124	$ 632

(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 $5.5 million 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. As of December 31, 2010, the Corporation had $19.7 million of impaired loans and leases that did not require an impairment reserve, and $19.4 million of impaired loans and leases that did require a specific reserve of $3.5 million. Average total impaired loans and leases was $29.7 million as of December 31, 2010. Net foregone interest on impaired loans was $2.6 million for the year ended December 31, 2010. For the three months ended March 31, 2010, net foregone interest was $486,000.

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. If a loan or lease is determined to be impaired, then the Corporation analyzes the impaired loans and leases 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 of the previously identified 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 Three Months Ended March 31, 2011				
	Commercial real estate	Commercial and industrial	Consumer and other	Direct Financing Lease, Net	Total
	(Dollars in Thousands)				
Allowance for credit losses:					
Beginning balance	$ 11,267	$ 4,277	$ 482	$ 245	$ 16,271
Charge-offs	(801)	(1)	(99)		(901)
Recoveries		9	11	8	28
Provision	1,309	77	49	(31)	1,404
Ending Balance	$ 11,775	$ 4,362	$ 443	$ 222	$ 16,802
Ending balance: individually evaluated for impairment	$ 2,767	$ 919	$ 92	$	$ 3,778
Ending balance: collectively evaluated for impairment	$ 9,008	$ 3,443	$ 351	$ 222	$ 13,024
Ending balance: loans acquired with deteriorated credit quality	$	$	$	$	$
Loans and lease receivables:					
Ending balance, gross	$ 619,021	$ 212,780	$ 19,369	$ 17,516	$ 868,686
Ending balance: individually evaluated for impairment	$ 30,700	$ 5,564	$ 2,926	$	$ 39,190
Ending balance: collectively evaluated for impairment	$ 588,321	$ 207,216	$ 16,443	$ 17,516	$ 829,496

Ending balance: loans acquired with deteriorated credit quality	$	$	$	$	$
Allowance as % of gross loans	1.90%	2.05%	2.29%	1.27%	1.93%

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Note 8 Deposits

Deposits consisted of the following:

	March 31, 2011			December 31, 2010		
	Balance	Weighted average balance	Weighted average rate	Balance	Weighted average balance	Weighted average rate
			(Dollars In Thousands)			
Transaction accounts:						
Demand deposits	$ 106,862	$ 102,302	%	$ 88,529	68,430	%
NOW accounts	25,813	30,584	0.27	44,428	74,784	0.35
Total transaction accounts:	132,675	132,886		132,957	143,214	
Money market accounts	287,201	294,434	0.98	276,748	258,569	1.08
Certificates of deposit	85,170	82,177	1.55	79,491	84,828	2.03
Brokered certificates of deposit	491,034	495,028	2.90	499,102	480,709	3.32
Total deposits	$ 996,080	$ 1,004,525		$ 988,298	967,320	

Note 9 FHLB Advances, Other Borrowings and Junior Subordinated Notes Payable

The composition of borrowed funds at March 31, 2011 and December 31, 2010 was as follows:

	March 31, 2011			December 31, 2010		
	Balance	Weighted Average Balance	Weighted Average Rate	Balance	Weighted Average Balance	Weighted Average Rate
			(Dollars In Thousands)			
Federal funds purchased	$	512	0.85%	$	$	%
FHLB advances	491	1,159	5.44	2,494	13,414	4.78
Line of credit	10	8,868	4.00	10	10	4.06
Subordinated notes payable	39,000	39,000	5.70	39,000	39,000	5.55
Junior subordinated notes	10,315	10,315	10.63	10,315	10,315	10.78
	$ 49,816	59,854		$ 51,819	$ 62,739	6.26
Short-term borrowings	$ 10			$ 2,010		
Long-term borrowings	49,806			49,809		
	$ 49,816			$ 51,819		

As of March 31, 2011, 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 three months ended March 31, 2011 and 2010, the Corporation incurred unused line fee interest expense of $1,000 and $1,000, respectively.

Note 10 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.

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

	Fair Value Measurements Using			
	Level 1	Level 2	Level 3	Total
		(In Thousands)		
March 31, 2011				
Assets:				
Collateralized mortgage obligations government agencies	$	$ 159,369	$	$ 159,369
Collateralized mortgage obligations government sponsored enterprises		424		424
Interest rate swaps		2,372		2,372
Liabilities:				
Interest rate swaps	$	$ 2,372	$	$ 2,372

	Fair Value Measurements Using			
	Level 1	Level 2	Level 3	Total
		(In Thousands)		
December 31, 2010				
Assets:				
Collateralized mortgage obligations government agencies	$	$ 152,776	$	$ 152,776
Collateralized mortgage obligations government sponsored enterprises		603		603
Interest rate swaps		2,841		2,841
Liabilities:				
Interest rate swaps	$	$ 2,841	$	$ 2,841

There were no transfers in or out of Level 1 or 2 during the three months ended March 31, 2011 or the year ended December 31, 2010.

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

	As of and for the Three Months Ended March 31, 2011				
	Balance at March 31, 2011	Fair Value Measurements Using Level 1	Level 2	Level 3	Total Gains (Losses)
	(In Thousands)				
Impaired loans	$ 22,175	$	$ 19,935	$ 2,240	$
Foreclosed properties	2,327		2,243	84	(69)

	As of and for the year ended December 31, 2010				
	Balance at December 31, 2010	Fair Value Measurements Using Level 1	Level 2	Level 3	Total Gains (Losses)
	(In Thousands)				
Impaired loans	$ 22,241	$	$ 18,112	$ 4,129	$
Foreclosed properties	1,750		1,660	90	(326)
Goodwill					(2,689)

Impaired loans that are collateral dependent were written down to their fair value of $22.2 million and $22.2 million at March 31, 2011 and December 31, 2010, respectively, through the establishment of specific reserves or by recording charge-offs when the carrying value exceeded the fair value. Valuation techniques consistent with the market approach, income approach, or cost approach were used to measure fair value and primarily included observable inputs for the individual impaired loans being evaluated such as recent sales of similar assets or observable market data for operational or carrying costs. In cases where such inputs were unobservable, the loan balance is reflected within Level 3 of the hierarchy.

Certain non-financial assets subject to measurement at fair value on a non-recurring basis included foreclosed properties. Foreclosed properties, upon initial recognition, are remeasured and reported at fair value through a charge-off to the allowance for loan and lease losses, if deemed necessary, based upon the fair value of the foreclosed property. The fair value of a foreclosed property, upon initial recognition, is estimated using Level 2 inputs based on observable market data, typically an appraisal, or Level 3 inputs based upon assumptions specific to the individual property or equipment. Subsequent impairments of foreclosed properties are recorded as a loss on foreclosed properties. During the three months ended March 31, 2011, $935,000 of outstanding loans were transferred to foreclosed properties as the Corporation claimed title to the respective assets. During the three months ended March 31, 2011, the Corporation completed an evaluation of certain of its foreclosed assets. Based upon the evaluation and the results of the impairment calculation, we recognized impairment losses of $69,000 on foreclosed properties for the three months ended March 31, 2011. At March 31, 2011 and December 31, 2010, foreclosed properties, at fair value, were $2.3 million and $1.8 million, respectively.

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Fair Value of Financial Instruments

The Corporation is required to disclose estimated fair values for its financial instruments. Fair value estimates, methods, and assumptions, consistent with exit price concepts for fair value measurements, are set forth below: