

FIRST UNITED CORP/MD/  
Form 10-Q  
May 13, 2013

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

**FORM 10-Q**

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF  
<sup>X</sup> 1934

For quarterly period ended March 31, 2013

.. TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE EXCHANGE ACT  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 0-14237

First United Corporation

(Exact name of registrant as specified in its charter)

Maryland 52-1380770  
(State or other jurisdiction of (I. R. S. Employer Identification No.)  
incorporation or organization)

19 South Second Street, Oakland, Maryland 21550-0009  
(Address of principal executive offices) (Zip Code)

(800) 470-4356

(Registrant's telephone number, including area code)

Edgar Filing: FIRST UNITED CORP/MD/ - Form 10-Q

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See definition 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

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

Indicate the number of shares outstanding of each of the issuer’s classes of common stock, as of the latest practicable date: 6,199,283 shares of common stock, par value \$.01 per share, as of April 30, 2013.

**INDEX TO QUARTERLY REPORT**

**FIRST UNITED CORPORATION**

|  |    |
|--|----|
| PART I. FINANCIAL INFORMATION  | 3  |
| Item 1. Financial Statements (unaudited)   | 3  |
| Consolidated Statement of Financial Condition – March 31, 2013 and December 31, 2012   | 3  |
| Consolidated Statement of Operations - for the three months ended March 31, 2013 and 2012  | 4  |
| Consolidated Statement of Comprehensive Income/(Loss) – for the three months ended March 31, 2013 and 2012                             | 5  |
| Consolidated Statement of Changes in Shareholders’ Equity - for the three months ended March 31, 2013 and year ended December 31, 2012 | 6  |
| Consolidated Statement of Cash Flows - for the three months ended March 31, 2013 and 2012  | 7  |
| Notes to Consolidated Financial Statements   | 8  |
| Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations  | 38 |
| Item 3. Quantitative and Qualitative Disclosures about Market Risk   | 56 |
| Item 4. Controls and Procedures  | 57 |
| PART II. OTHER INFORMATION   | 58 |
| Item 1. Legal Proceedings  | 58 |
| Item 1A. Risk Factors  | 58 |
| Item 2. Unregistered Sales of Equity Securities and Use of Proceeds  | 58 |
| Item 3. Defaults upon Senior Securities  | 58 |
| Item 4. Mine Safety Disclosures  | 58 |
| Item 5. Other Information  | 58 |
| Item 6. Exhibits   | 58 |
|  | 3  |

|               |    |
|---------------|----|
| SIGNATURES    | 58 |
| EXHIBIT INDEX | 59 |

**PART I. FINANCIAL INFORMATION****Item 1. Financial Statements****FIRST UNITED CORPORATION**

## Consolidated Statement of Financial Condition

(In thousands, except per share and percentage data)

|  | March 31,<br>2013<br>(Unaudited) | December 31,<br>2012 |
|--|----------------------------------|----------------------|
| Assets   |                                  |                      |
| Cash and due from banks                                    | \$71,592                         | \$ 71,290            |
| Interest bearing deposits in banks                         | 13,236                           | 11,778               |
| Cash and cash equivalents                                  | 84,828                           | 83,068               |
| Investment securities – available-for-sale (at fair value) | 239,440                          | 223,273              |
| Investment securities – held to maturity (at cost)         | 4,040                            | 4,040                |
| Restricted investment in bank stock, at cost               | 7,853                            | 8,349                |
| Loans  | 859,669                          | 874,829              |
| Allowance for loan losses                                  | (16,025 )                        | (16,047 )            |
| Net loans  | 843,644                          | 858,782              |
| Premises and equipment, net                                | 29,229                           | 29,455               |
| Goodwill and other intangible assets, net                  | 11,004                           | 11,004               |
| Bank owned life insurance                                  | 31,656                           | 31,407               |
| Deferred tax assets  | 27,871                           | 28,882               |
| Other real estate owned                                    | 16,188                           | 17,513               |
| Accrued interest receivable and other assets               | 27,014                           | 25,010               |
| Total Assets   | \$ 1,322,767                     | \$ 1,320,783         |
| Liabilities and Shareholders' Equity                       |                                  |                      |
| Liabilities:   |                                  |                      |
| Non-interest bearing deposits                              | \$ 184,288                       | \$ 161,500           |
| Interest bearing deposits                                  | 791,512                          | 815,384              |
| Total deposits   | 975,800                          | 976,884              |
| Short-term borrowings                                      | 38,633                           | 39,257               |
| Long-term borrowings                                       | 182,720                          | 182,735              |
| Accrued interest payable and other liabilities             | 23,679                           | 23,002               |
| Total Liabilities  | 1,220,832                        | 1,221,878            |
| Shareholders' Equity:                                      |                                  |                      |
| Preferred stock – no par value;                            |                                  |                      |

Edgar Filing: FIRST UNITED CORP/MD/ - Form 10-Q

|   |             |              |
|---|-------------|--------------|
| Authorized 2,000 shares of which 30 shares of Series A, \$1,000 per share liquidation preference, 5% cumulative increasing to 9% cumulative on February 15, 2014, were issued and outstanding on March 31, 2013 and December 31, 2012 (discount of \$58 and \$75, respectively) | 29,942      | 29,925       |
| Common Stock – par value \$.01 per share;<br>Authorized 25,000 shares; issued and outstanding 6,199 shares  | 62          | 62           |
| Surplus   | 21,592      | 21,573       |
| Retained earnings   | 70,653      | 69,168       |
| Accumulated other comprehensive loss  | (20,314 )   | (21,823 )    |
| Total Shareholders' Equity  | 101,935     | 98,905       |
| Total Liabilities and Shareholders' Equity  | \$1,322,767 | \$ 1,320,783 |

*See accompanying notes to the consolidated financial statements*

**FIRST UNITED CORPORATION**

## Consolidated Statement of Operations

(In thousands, except per share data)

|   | Three Months Ended<br>March 31, |           |
|---|---------------------------------|-----------|
|   | 2013                            | 2012      |
|   | (Unaudited)                     |           |
| Interest income   |                                 |           |
| Interest and fees on loans  | \$ 10,685                       | \$ 12,049 |
| Interest on investment securities                                       |                                 |           |
| Taxable   | 1,091                           | 1,162     |
| Exempt from federal income tax  | 428                             | 498       |
| Total investment income   | 1,519                           | 1,660     |
| Other   | 84                              | 59        |
| Total interest income   | 12,288                          | 13,768    |
| Interest expense  |                                 |           |
| Interest on deposits  | 1,327                           | 1,893     |
| Interest on short-term borrowings                                       | 14                              | 46        |
| Interest on long-term borrowings  | 1,614                           | 1,946     |
| Total interest expense  | 2,955                           | 3,885     |
| Net interest income   | 9,333                           | 9,883     |
| Provision for loan losses   | 865                             | 8,124     |
| Net interest income after provision for loan losses                     | 8,468                           | 1,759     |
| Other operating income  |                                 |           |
| Changes in fair value on impaired securities                            | 1,663                           | 328       |
| Portion of gain recognized in other comprehensive income (before taxes) | (1,663 )                        | (328 )    |
| Net securities impairment losses recognized in operations               | 0                               | 0         |
| Net gains – other   | 329                             | 703       |
| Total net gains   | 329                             | 703       |
| Service charges   | 874                             | 862       |
| Trust department  | 1,196                           | 1,115     |
| Insurance commissions   | 1                               | 6         |
| Debit card income   | 476                             | 492       |
| Bank owned life insurance   | 249                             | 971       |
| Brokerage commissions   | 162                             | 185       |
| Other   | 369                             | 421       |
| Total other income  | 3,327                           | 4,052     |
| Total other operating income  | 3,656                           | 4,755     |
| Other operating expenses  |                                 |           |
| Salaries and employee benefits  | 4,844                           | 4,889     |
| FDIC premiums   | 451                             | 465       |
| Equipment   | 642                             | 682       |
| Occupancy   | 704                             | 710       |

Edgar Filing: FIRST UNITED CORP/MD/ - Form 10-Q

|  |          |             |
|--|----------|-------------|
| Data processing  | 729      | 680         |
| Other  | 2,264    | 1,714       |
| Total other operating expenses   | 9,634    | 9,140       |
| Income/(Loss) before income tax expense                                | 2,490    | (2,626 )    |
| Applicable income tax expense  | 568      | 39          |
| Net Income/(Loss)  | 1,922    | (2,665 )    |
| Accumulated preferred stock dividends and discount accretion           | (437 )   | (415 )      |
| Net Income Available to/Net (Loss) Attributable to Common Shareholders | \$ 1,485 | \$ (3,080 ) |
| Basic and diluted net income/(loss) per common share                   | \$ 0.24  | \$ (0.50 )  |
| Weighted average number of basic and diluted shares outstanding        | 6,199    | 6,183       |

*See accompanying notes to the consolidated financial statements*



**FIRST UNITED CORPORATION**

## Consolidated Statement of Comprehensive Income/(Loss)

(In thousands, except per share data)

|  | Three Months Ended<br>March 31, |                    |
|--|---------------------------------|--------------------|
|  | 2013                            | 2012               |
| <b>Comprehensive Income/(Loss) (in thousands)</b>                        |                                 |                    |
| Net Income/(Loss)  | \$ 1,922                        | \$ (2,665 )        |
| Other comprehensive income, net of tax and reclassification adjustments: |                                 |                    |
| Net unrealized gains on investments with OTTI                            | 995                             | 196                |
| Net unrealized losses on all other AFS securities                        | (265 )                          | (122 )             |
| Net unrealized gains on cash flow hedges                                 | 60                              | 27                 |
| Net unrealized gains on Pension  | 715                             | 0                  |
| Net unrealized gains on SERP   | 4                               | 0                  |
| Other comprehensive income, net of tax                                   | 1,509                           | 101                |
| <b>Comprehensive income /(loss)</b>                                      | <b>\$ 3,431</b>                 | <b>\$ (2,564 )</b> |

*See accompanying notes to the consolidated financial statements*

**FIRST UNITED CORPORATION**

## Consolidated Statement of Changes in Shareholders' Equity

(In thousands, except share and per share data)

|                                    | Preferred<br>Stock | Common<br>Stock | Surplus   | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Loss | Total<br>Shareholders'<br>Equity |
|------------------------------------|--------------------|-----------------|-----------|----------------------|---|----------------------------------|
| Balance at January 1, 2012         | \$ 29,860          | \$ 62           | \$ 21,500 | \$ 66,196            | \$ (20,962)                                   | ) \$ 96,656                      |
| Net income                         |                    |                 |           | 4,663                |   | 4,663                            |
| Other comprehensive loss           |                    |                 |           |                      | (861)   | ) (861)                          |
| Stock based compensation           |                    |                 | 73        |                      |   | 73                               |
| Preferred stock discount accretion | 65                 |                 |           | (65)                 |   | 0                                |
| Preferred stock dividends deferred |                    |                 |           | (1,626)              |   | ) (1,626)                        |
| Balance at December 31, 2012       | 29,925             | 62              | 21,573    | 69,168               | (21,823)                                      | ) 98,905                         |
| Net income                         |                    |                 |           | 1,922                |   | 1,922                            |
| Other comprehensive income         |                    |                 |           |                      | 1,509   | 1,509                            |
| Stock based compensation           |                    |                 | 19        |                      |   | 19                               |
| Preferred stock discount accretion | 17                 |                 |           | (17)                 |   | 0                                |
| Preferred stock dividends deferred |                    |                 |           | (420)                |   | ) (420)                          |
| Balance at March 31, 2013          | \$ 29,942          | \$ 62           | \$ 21,592 | \$ 70,653            | \$ (20,314)                                   | ) \$ 101,935                     |

*See accompanying notes to the consolidated financial statements*

**FIRST UNITED CORPORATION**

## Consolidated Statement of Cash Flows

(In thousands)

|  | Three Months Ended<br>March 31, |            |
|--|---------------------------------|------------|
|  | 2013                            | 2012       |
|  | (Unaudited)                     |            |
| Operating activities   |                                 |            |
| Net income/(loss)  | \$1,922                         | \$(2,665 ) |
| Adjustments to reconcile net income/(loss) to net cash provided by operating activities: |                                 |            |
| Provision for loan losses  | 865                             | 8,124      |
| Depreciation   | 509                             | 515        |
| Stock compensation   | 19                              | 13         |
| Gain on sales of Insurance assets  | 0                               | (88 )      |
| Gain on sales of other real estate owned   | (7 )                            | (623 )     |
| Write-downs of other real estate owned   | 20                              | 0          |
| Gain on loan sales   | (79 )                           | (20 )      |
| Loss on disposal of fixed assets   | 0                               | 4          |
| Net amortization of investment securities discounts and premiums                         | 395                             | 375        |
| Gain on sales of investment securities – available-for-sale                              | (250 )                          | (599 )     |
| Amortization of deferred Loan Fees   | (191 )                          | (127 )     |
| Decrease in accrued interest receivable and other assets                                 | (810 )                          | 781        |
| Deferred tax benefit   | 1                               | (1,469 )   |
| Increase/(decrease) in accrued interest payable and other liabilities                    | 364                             | (3,076 )   |
| Earnings on bank owned life insurance  | (249 )                          | (971 )     |
| Net cash provided by operating activities  | 2,509                           | 174        |
| Investing activities   |                                 |            |
| Proceeds from maturities/calls of investment securities available-for-sale               | 13,381                          | 8,414      |
| Proceeds from sales of investment securities available-for-sale                          | 35,136                          | 10,454     |
| Purchases of investment securities available-for-sale                                    | (63,611 )                       | (3,686 )   |
| Proceeds from sales of other real estate owned   | 1,765                           | 2,708      |
| Proceeds from loan sales   | 11,313                          | 1,462      |
| Proceeds from disposal of fixed assets   | 0                               | 19         |
| Proceeds from sale of insurance assets   | 0                               | 3,604      |
| Proceeds from BOLI death benefit   | 0                               | 1,765      |
| Net decrease in FHLB stock   | 496                             | 0          |
| Net decrease in loans  | 2,777                           | 8,113      |
| Purchases of premises and equipment  | (283 )                          | (224 )     |
| Net cash provided by investing activities  | 974                             | 32,629     |
| Financing activities   |                                 |            |
| Net (decrease)/increase in deposits  | (1,084 )                        | 2,121      |

Edgar Filing: FIRST UNITED CORP/MD/ - Form 10-Q

|  |          |           |
|--|----------|-----------|
| Net decrease in short-term borrowings                            | (624 )   | (1,641 )  |
| Proceeds from long-term borrowings                               | 0        | 20,000    |
| Payments on long-term borrowings                                 | (15 )    | (20,265 ) |
| Net cash (used in)/ provided by financing activities             | (1,723 ) | 215       |
| Increase in cash and cash equivalents                            | 1,760    | 33,018    |
| Cash and cash equivalents at beginning of the year               | 83,068   | 65,107    |
| Cash and cash equivalents at end of period                       | \$84,828 | \$98,125  |
| Supplemental information   |          |           |
| Interest paid  | \$2,489  | \$3,553   |
| Non-cash investing activities:                                   |          |           |
| Transfers from loans to other real estate owned                  | \$453    | \$4,527   |
| Transfers from securities available for sale to held-to-maturity | \$0      | \$4,040   |

*See accompanying notes to the consolidated financial statements*

## **FIRST UNITED CORPORATION**

NoteS to Consolidated Financial Statements (UNAUDITED)

for the quarter ended march 31, 2013

### **Note 1 – Basis of Presentation**

The accompanying unaudited consolidated financial statements of First United Corporation and its consolidated subsidiaries, including First United Bank & Trust (the “Bank”), have been prepared in accordance with U.S. generally accepted accounting principles (“GAAP”) for interim financial information, as required by the Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”) Topic 270, *Interim Reporting*, and with the instructions to Form 10-Q and Rule 8-03 of Regulation S-X. Accordingly, they do not include all the information and footnotes required for annual financial statements. In the opinion of management, all adjustments considered necessary for a fair presentation, consisting of normal recurring items, have been included. Operating results for the three-month period ended March 31, 2013 are not necessarily indicative of the results that may be expected for the full year or for any future interim period. These consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in First United Corporation’s Annual Report on Form 10-K for the year ended December 31, 2012. For purposes of comparability, certain prior period amounts have been reclassified to conform to the 2013 presentation. Such reclassifications had no impact on net income or equity.

First United Corporation has evaluated events and transactions occurring subsequent to the statement of financial condition date of March 31, 2013 for items that should potentially be recognized or disclosed in these financial statements as prescribed by ASC Topic 855, *Subsequent Events*.

As used in these notes to consolidated financial statements, First United Corporation and its consolidated subsidiaries are sometimes collectively referred to as the “Corporation”.

### **Note 2 – Earnings/(Loss) Per Common Share**

Basic earnings/(loss) per common share is derived by dividing net income available to/loss attributable to common shareholders by the weighted-average number of common shares outstanding during the period and does not include the effect of any potentially dilutive common stock equivalents. Diluted earnings/(loss) per share is derived by dividing net income available to/loss attributable to common shareholders by the weighted-average number of shares outstanding, adjusted for the dilutive effect of outstanding common stock equivalents. There is no dilutive effect on earnings per share during loss periods. There were no common stock equivalents during the three-months ended

March 31, 2013 and 2012.

The following table sets forth the calculation of basic and diluted earnings/(loss) per common share for the three-month periods ended March 31, 2013 and 2012:

|  | For the three months ended March 31, |         |         |           |         |            |
|--|--------------------------------------|---------|---------|-----------|---------|------------|
|  | 2013                                 |         |         | 2012      |         |            |
|  |                                      | Average | Per     |           | Average | Per        |
| (in thousands, except for per share amount)                            | Income                               | Shares  | Share   | Loss      | Shares  | Share      |
| Basic and Diluted Earnings/(Loss) Per Share:                           |                                      |         | Amount  |           |         | Amount     |
| Net income/(loss)  | \$1,922                              |         |         | \$(2,665) |         |            |
| Preferred stock dividends deferred                                     | (420 )                               |         |         | (399 )    |         |            |
| Discount accretion on preferred stock                                  | (17 )                                |         |         | (16 )     |         |            |
| Net income available to/Net (loss) attributable to common shareholders | \$1,485                              | 6,199   | \$ 0.24 | \$(3,080) | 6,183   | \$ (0.50 ) |

**Note 3 – Net Gains**

The following table summarizes the gain/(loss) activity for the three-month periods ended March 31, 2013 and 2012:

| (in thousands)                   | Three months ended |        |
|----------------------------------|--------------------|--------|
|                                  | March 31,          |        |
|                                  | 2013               | 2012   |
| Net gains/(losses) – other:      |                    |        |
| Available-for-sale securities:   |                    |        |
| Realized gains                   | 412                | 663    |
| Realized losses                  | (162 )             | (64 )  |
| Gain on sale of consumer loans   | 79                 | 20     |
| Gain on sale of insurance assets | 0                  | 88     |
| Loss on disposal of fixed assets | 0                  | (4 )   |
| Net gains – other                | \$ 329             | \$ 703 |

**Note 4 – Cash and Cash Equivalents**

Cash and due from banks, which represents vault cash in the retail offices and invested cash balances at the Federal Reserve, is carried at fair value.

|  | March 31,<br>2013 | December 31,<br>2012 |
|--|-------------------|----------------------|
| Cash and due from banks, weighted average interest rate of 0.18% (at March 31, 2013) | \$ 71,592         | \$ 71,290            |

Interest bearing deposits in banks, which represent funds invested at a correspondent bank, are carried at fair value and, as of March 31, 2013 and December 31, 2012, consisted of daily funds invested at the Federal Home Loan Bank (“FHLB”) of Atlanta, First Tennessee Bank (“FTN”), Merchants and Traders (“M&T”) and Community Bankers Bank (“CBB”).

|   | March 31,<br>2013 | December 31,<br>2012 |
|---|-------------------|----------------------|
| FHLB daily investments, interest rate of 0.005% (at March 31, 2013) | \$ 4,760          | \$ 3,306             |
| FTN daily investments, interest rate of 0.09% (at March 31, 2013)   | 1,350             | 1,350                |
| M&T daily investments, interest rate of 0.25% (at March 31, 2013)   | 6,041             | 6,037                |
| CBB Fed Funds sold, interest rate of 0.21% (at March 31, 2013)      | 1,085             | 1,085                |

\$ 13,236    \$ 11,778

**Note 5 – Investments**

The investment portfolio is classified and accounted for based on the guidance of ASC Topic 320, *Investments – Debt and Equity Securities*.

The amortized cost of debt securities classified as available-for-sale is adjusted for the amortization of premiums to the first call date, if applicable, or to maturity, and for the accretion of discounts to maturity, or, in the case of mortgage-backed securities, over the estimated life of the security. Such amortization and accretion is included in interest income from investments. Interest and dividends are included in interest income from investments. Gains and losses on the sale of securities are recorded using the specific identification method.



The following table shows a comparison of amortized cost and fair values of investment securities at March 31, 2013 and December 31, 2012:

| (in thousands)                                   | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value | OTTI in AOCI |
|--|----------------|------------------------|-------------------------|------------|--------------|
| March 31, 2013                                   |                |                        |                         |            |              |
| Available for Sale:                              |                |                        |                         |            |              |
| U.S. government agencies                         | \$ 47,425      | \$ 94                  | \$ 291                  | \$ 47,228  | \$ 0         |
| Residential mortgage-backed agencies             | 81,432         | 681                    | 695                     | 81,418     | 0            |
| Commercial mortgage-backed agencies              | 14,934         | 92                     | 0                       | 15,026     | 0            |
| Collateralized mortgage obligations              | 23,054         | 246                    | 21                      | 23,279     | 0            |
| Obligations of states and political subdivisions | 56,308         | 2,482                  | 99                      | 58,691     | 0            |
| Collateralized debt obligations                  | 36,902         | 35                     | 23,139                  | 13,798     | 15,215       |
| Total available for sale                         | \$ 260,055     | \$ 3,630               | \$ 24,245               | \$ 239,440 | \$ 15,215    |
| Held to Maturity:                                |                |                        |                         |            |              |
| Obligations of states and political subdivisions | \$ 4,040       | \$ 461                 | \$ 183                  | \$ 4,318   | \$ 0         |
| December 31, 2012                                |                |                        |                         |            |              |
| Available for Sale:                              |                |                        |                         |            |              |
| U.S. government agencies                         | \$ 40,334      | \$ 97                  | \$ 111                  | \$ 40,320  | \$ 0         |
| Residential mortgage-backed agencies             | 43,596         | 703                    | 191                     | 44,108     | 0            |
| Commercial mortgage-backed agencies              | 37,330         | 288                    | 0                       | 37,618     | 0            |
| Collateralized mortgage obligations              | 31,836         | 188                    | 293                     | 31,731     | 0            |
| Obligations of states and political subdivisions | 55,212         | 2,842                  | 0                       | 58,054     | 0            |
| Collateralized debt obligations                  | 36,798         | 0                      | 25,356                  | 11,442     | 16,876       |
| Total available for sale                         | \$ 245,106     | \$ 4,118               | \$ 25,951               | \$ 223,273 | \$ 16,876    |
| Held to Maturity:                                |                |                        |                         |            |              |
| Obligations of states and political subdivisions | \$ 4,040       | \$ 542                 | \$ 235                  | \$ 4,347   | \$ 0         |

Proceeds from sales of securities and the realized gains and losses are as follows:

| (in thousands)  | Three Months Ended |                |
|-----------------|--------------------|----------------|
|                 | March 31, 2013     | March 31, 2012 |
| Proceeds        | \$ 35,136          | \$ 10,454      |
| Realized gains  | 412                | 663            |
| Realized losses | 162                | 64             |

The following table shows the Corporation's securities with gross unrealized losses and fair values at March 31, 2013 and December 31, 2012, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position:

| (in thousands)                                   | Less than 12 months |                   | 12 months or more |                   |
|--|---------------------|-------------------|-------------------|-------------------|
|  | Fair Value          | Unrealized Losses | Fair Value        | Unrealized Losses |
| March 31, 2013                                   |                     |                   |                   |                   |
| Available for Sale:                              |                     |                   |                   |                   |
| U.S. government agencies                         | \$18,041            | \$ 291            | \$0               | \$ 0              |
| Residential mortgage-backed agencies             | 56,952              | 695               | 0                 | 0                 |
| Commercial mortgage-backed agencies              | 0                   | 0                 | 0                 | 0                 |
| Collateralized mortgage obligations              | 0                   | 0                 | 3,964             | 21                |
| Obligations of states and political subdivisions | 12,789              | 99                | 0                 | 0                 |
| Collateralized debt obligations                  | 0                   | 0                 | 13,508            | 23,139            |
| Total available for sale                         | \$87,782            | \$ 1,085          | \$17,472          | \$ 23,160         |
| Held to Maturity:                                |                     |                   |                   |                   |
| Obligations of states and political subdivisions | \$2,817             | \$ 183            | \$0               | \$ 0              |
| December 31, 2012                                |                     |                   |                   |                   |
| Available for Sale:                              |                     |                   |                   |                   |
| U.S. government agencies                         | \$18,220            | \$ 111            | \$0               | \$ 0              |
| Residential mortgage-backed agencies             | 22,407              | 191               | 0                 | 0                 |
| Commercial mortgage-backed agencies              | 0                   | 0                 | 0                 | 0                 |
| Collateralized mortgage obligations              | 16,576              | 293               | 450               | 0                 |
| Obligations of states and political subdivisions | 0                   | 0                 | 0                 | 0                 |
| Collateralized debt obligations                  | 0                   | 0                 | 11,442            | 25,356            |
| Total available for sale                         | \$57,203            | \$ 595            | \$11,892          | \$ 25,356         |
| Held to Maturity:                                |                     |                   |                   |                   |
| Obligations of states and political subdivisions | \$2,765             | \$ 235            | \$0               | \$ 0              |

\* - De minimis

Management systematically evaluates securities for impairment on a quarterly basis. Management assesses whether (a) the Corporation has the intent to sell a security being evaluated and (b) it is more likely than not that the Corporation will be required to sell the security prior to its anticipated recovery. If neither applies, then declines in the fair values of securities below their cost that are considered other-than-temporary declines are split into two components. The first is the loss attributable to declining credit quality. Credit losses are recognized in earnings as realized losses in the period in which the impairment determination is made. The second component consists of all other losses, which are recognized in other comprehensive loss. In estimating other-than-temporary impairment ("OTTI") losses, management considers (1) the length of time and the extent to which the fair value has been less than cost, (2) adverse conditions specifically related to the security, an industry, or a geographic area, (3) the historic and implied volatility of the fair value of the security, (4) changes in the rating of the security by a rating agency, (5) recoveries or additional declines in fair value subsequent to the balance sheet date, (6) failure of the issuer of the security to make scheduled interest or principal payments, and (7) the payment structure of the debt security and the likelihood of the issuer being able to make payments that increase in the future. Management also monitors cash flow

projections for securities that are considered beneficial interests under the guidance of ASC Subtopic 325-40, *Investments – Other – Beneficial Interests in Securitized Financial Assets*, (ASC Section 325-40-35). Further discussion about the evaluation of securities for impairment can be found in Item 2 of Part I of this report under the heading “*Investment Securities*”.

Management believes that the valuation of certain securities is a critical accounting policy that requires significant estimates in preparation of its consolidated financial statements. Management utilizes an independent third party to prepare both the impairment valuations and fair value determinations for its collateralized debt obligation (“CDO”) portfolio consisting of pooled trust preferred securities. Based on management’s review of the assumptions and results of the third-party review, it does not believe that there were any material differences in the valuations between March 31, 2013 and December 31, 2012.

U.S. Government Agencies - Three U.S. government agencies have been in an unrealized loss position for less than 12 months as of March 31, 2013. There were no U.S. government agencies in an unrealized loss position for 12 months or more. The securities are of the highest investment grade and the Corporation does not intend to sell them, and it is not more likely than not that the Corporation will be required to sell them before recovery of their amortized cost basis, which may be at maturity. Accordingly, management does not consider these investments to be other-than-temporarily impaired at March 31, 2013.

Residential Mortgage-Backed Agencies - Nine residential mortgage-backed agencies have been in an unrealized loss position for less than 12 months as of March 31, 2013. There were no residential mortgage-backed agency securities in an unrealized loss position for 12 months or more. The securities are of the highest investment grade and the Corporation does not intend to sell them, and it is not more likely than not that the Corporation will be required to sell the securities before recovery of their amortized cost basis, which may be at maturity. Accordingly, management does not consider these investments to be other-than-temporarily impaired at March 31, 2013.

Collateralized Mortgage Obligations - One collateralized mortgage obligation security at March 31, 2013 was in an unrealized loss position for 12 months or more. There were no collateralized mortgage obligation securities in an unrealized loss position for less than 12 months. The security is of the highest investment grade and the Corporation does not intend to sell it, and it is not more likely than not that the Corporation will be required to sell the security before recovery of its amortized cost basis. Accordingly, management does not consider these investments to be other-than-temporarily impaired at March 31, 2013.

Obligations of State and Political Subdivisions - Four securities have been in an unrealized loss position for less than 12 months. There are no securities that have been in an unrealized loss position for 12 months or more. These investments are of investment grade as determined by the major rating agencies and management reviews the ratings of the underlying issuers. Management believes that this portfolio is well-diversified throughout the United States, and all bonds continue to perform according to their contractual terms. The Corporation does not intend to sell these investments and it is not more likely than not that the Corporation will be required to sell the investments before recovery of their amortized cost basis, which may be at maturity. Accordingly, management does not consider these investments to be other-than-temporarily impaired at March 31, 2013.

Collateralized Debt Obligations - The \$23.1 million in unrealized losses greater than 12 months at March 31, 2013 relates to 17 pooled trust preferred securities that are included in the CDO portfolio. See Note 8 for a discussion of the methodology used by management to determine the fair values of these securities. Based upon a review of credit quality and the cash flow tests performed by the independent third party, management determined that there were no securities that had credit-related non-cash OTTI charges during the first three months of 2013. The unrealized losses on the remaining securities in the portfolio are primarily attributable to continued depression in market interest rates, marketability, liquidity and the current economic environment.

The following tables present a cumulative roll-forward of the amount of non-cash OTTI charges related to credit losses which have been recognized in earnings for the trust preferred securities in the CDO portfolio held and not intended to be sold for the three-month periods ended March 31, 2013 and 2012:

| (in thousands)  | Three Months Ended March |           |
|---|--------------------------|-----------|
|   | 31,<br>2013              | 2012      |
| Balance of credit-related OTTI at January 1   | \$ 13,959                | \$ 14,424 |
| Additions for credit-related OTTI not previously recognized   | 0                        | 0         |
| Additional increases for credit-related OTTI previously recognized when there is no intent to sell and no requirement to sell before recovery of amortized cost basis | 0                        | 0         |
| Decreases for previously recognized credit-related OTTI because there was an intent to sell   | 0                        | 0         |
| Reduction for increases in cash flows expected to be collected  | (125 )                   | (112 )    |
| Balance of credit-related OTTI at March 31  | \$ 13,834                | \$ 14,312 |

The amortized cost and estimated fair value of securities by contractual maturity at March 31, 2013 is shown in the following table. Actual maturities may differ from contractual maturities because the issuers of the securities may have the right to call or prepay obligations with or without call or prepayment penalties.

| (in thousands)                         | March 31, 2013 |            |
|--|----------------|------------|
|  | Amortized Cost | Fair Value |
| <b>Contractual Maturity</b>            |                |            |
| Available for sale:                    |                |            |
| Due after five years through ten years | \$59,452       | \$60,636   |
| Due after ten years                    | 81,183         | 59,081     |
|  | 140,635        | 119,717    |
| Residential mortgage-backed agencies   | 81,432         | 81,418     |
| Commercial mortgage-backed agencies    | 14,934         | 15,026     |
| Collateralized mortgage obligations    | 23,054         | 23,279     |
|  | \$260,055      | \$239,440  |
| Held to Maturity:                      |                |            |
| Due after ten years                    | \$4,040        | \$4,318    |

#### **Note 6 - Restricted Investment in Bank Stock**

Restricted stock, which represents required investments in the common stock of the FHLB of Atlanta, Atlantic Central Bankers Bank (“ACBB”) and CBB, is carried at cost and is considered a long-term investment.

Management evaluates the restricted stock for impairment in accordance with ASC Industry Topic 942, *Financial Services – Depository and Lending*, (ASC Section 942-325-35). Management’s evaluation of potential impairment is based on management’s assessment of the ultimate recoverability of the cost of the restricted stock rather than by recognizing temporary declines in value. The determination of whether a decline affects the ultimate recoverability is influenced by criteria such as (a) the significance of the decline in net assets of the issuing bank as compared to the capital stock amount for that bank and the length of time this situation has persisted, (b) commitments by the issuing bank to make payments required by law or regulation and the level of such payments in relation to the operating performance of that bank, and (c) the impact of legislative and regulatory changes on institutions and, accordingly, on the customer base of the issuing bank. Management has evaluated the restricted stock for impairment and believes that no impairment charge is necessary as of March 31, 2013.

The Corporation recognizes dividends on a cash basis. For the three months ended March 31, 2013, dividends of \$50,517 were recognized in earnings. For the comparable period of 2012, dividends of \$34,008 were recognized in earnings.



**Note 7 – Loans and Related Allowance for Loan Losses**

The following table summarizes the primary segments of the loan portfolio as of March 31, 2013 and December 31, 2012:

| (in thousands)                        | Commercial Real Estate | Acquisition and Development | Commercial and Industrial | Residential Mortgage | Consumer  | Total      |
|---------------------------------------|------------------------|-----------------------------|---------------------------|----------------------|-----------|------------|
| March 31, 2013                        |                        |                             |                           |                      |           |            |
| Total loans                           | \$ 290,619             | \$ 124,142                  | \$ 68,380                 | \$ 348,979           | \$ 27,549 | \$ 859,669 |
| Individually evaluated for impairment | \$ 15,990              | \$ 24,242                   | \$ 3,415                  | \$ 4,736             | \$ 116    | \$ 48,499  |
| Collectively evaluated for impairment | \$ 274,629             | \$ 99,900                   | \$ 64,965                 | \$ 344,243           | \$ 27,433 | \$ 811,170 |
| December 31, 2012                     |                        |                             |                           |                      |           |            |
| Total loans                           | \$ 298,851             | \$ 128,391                  | \$ 69,013                 | \$ 346,919           | \$ 31,655 | \$ 874,829 |
| Individually evaluated for impairment | \$ 15,941              | \$ 24,112                   | \$ 3,449                  | \$ 4,304             | \$ 36     | \$ 47,842  |
| Collectively evaluated for impairment | \$ 282,910             | \$ 104,279                  | \$ 65,564                 | \$ 342,615           | \$ 31,619 | \$ 826,987 |

The segments of the Bank's loan portfolio are disaggregated to a level that allows management to monitor risk and performance. The commercial real estate ("CRE") loan segment is then segregated into two classes. Non-owner occupied CRE loans, which include loans secured by non-owner occupied, nonfarm, and nonresidential properties, generally have a greater risk profile than all other CRE loans, which include loans secured by farmland, multifamily structures and owner-occupied commercial structures. The acquisition and development ("A&D") loan segment is segregated into two classes. One-to-four family residential construction loans are generally made to individuals for the acquisition of and/or construction on a lot or lots on which a residential dwelling is to be built. All other A&D loans are generally made to developers or investors for the purpose of acquiring, developing and constructing residential or commercial structures. These loans have a higher risk profile because the ultimate buyer, once development is completed, is generally not known at the time of the A&D loan. The commercial and industrial ("C&I") loan segment consists of loans made for the purpose of financing the activities of commercial customers. The residential mortgage loan segment is segregated into two classes: (a) amortizing term loans, which are primarily first liens; and (b) home equity lines of credit, which are generally second liens. The consumer loan segment consists primarily of installment loans (direct and indirect) and overdraft lines of credit connected with customer deposit accounts.

Management uses a 10-point internal risk rating system to monitor the credit quality of the overall loan portfolio. The first six categories are considered not criticized, and are aggregated as "Pass" rated. The criticized rating categories utilized by management generally follow bank regulatory definitions. The Special Mention category includes assets



that are currently protected but are potentially weak, resulting in an undue and unwarranted credit risk, but not to the point of justifying a Substandard classification. Loans in the Substandard category have well-defined weaknesses that jeopardize the liquidation of the debt, and have a distinct possibility that some loss will be sustained if the weaknesses are not corrected. All loans greater than 90 days past due are considered Substandard. The portion of a specific allocation of the allowance for loan losses that management believes is associated with a pending event that could trigger loss in the short-term will be classified in the Doubtful category. Any portion of a loan that has been charged off is placed in the Loss category.

To help ensure that risk ratings are accurate and reflect the present and future capacity of borrowers to repay a loan as agreed, the Bank has a structured loan rating process with several layers of internal and external oversight. Generally, consumer and residential mortgage loans are included in the Pass categories unless a specific action, such as bankruptcy, repossession, or death occurs to raise awareness of a possible credit event. The Bank's Commercial Loan Officers are responsible for the timely and accurate risk rating of the loans in the commercial segments at origination and on an ongoing basis. The Bank's experienced Credit Quality and Loan Review Department performs an annual review of all commercial relationships of \$500,000 or greater. Confirmation of the appropriate risk grade is included as part of the review process on an ongoing basis. The Credit Quality and Loan Review Department continually reviews and assesses loans within the portfolio. In addition, the Bank engages an external consultant to conduct loan reviews on at least an annual basis. Generally, the external consultant reviews commercial relationships greater than \$750,000 and/or criticized relationships greater than \$500,000. Detailed reviews, including plans for resolution, are performed on loans classified as Substandard on a quarterly basis. Loans in the Special Mention and Substandard categories that are collectively evaluated for impairment are given separate consideration in the determination of the allowance.

The following table presents the classes of the loan portfolio summarized by the aggregate Pass and the criticized categories of Special Mention, Substandard and Doubtful within the internal risk rating system as of March 31, 2013 and December 31, 2012:

| (in thousands)                      | Pass       | Special Mention | Substandard | Doubtful | Total      |
|-------------------------------------|------------|-----------------|-------------|----------|------------|
| March 31, 2013                      |            |                 |             |          |            |
| Commercial real estate              |            |                 |             |          |            |
| Non owner-occupied                  | \$ 125,892 | \$ 3,705        | \$ 20,855   | \$ 0     | \$ 150,452 |
| All other CRE                       | 102,255    | 8,995           | 28,917      | 0        | 140,167    |
| Acquisition and development         |            |                 |             |          |            |
| 1-4 family residential construction | 8,216      | 1,096           | 5,948       | 0        | 15,260     |
| All other A&D                       | 75,005     | 2,185           | 31,692      | 0        | 108,882    |
| Commercial and industrial           | 60,502     | 1,973           | 5,905       | 0        | 68,380     |
| Residential mortgage                |            |                 |             |          |            |
| Residential mortgage - term         | 260,459    | 744             | 11,171      | 0        | 272,374    |
| Residential mortgage - home equity  | 74,329     | 288             | 1,988       | 0        | 76,605     |
| Consumer                            | 27,184     | 21              | 344         | 0        | 27,549     |
| Total                               | \$ 733,842 | \$ 19,007       | \$ 106,820  | \$ 0     | \$ 859,669 |
| December 31, 2012                   |            |                 |             |          |            |
| Commercial real estate              |            |                 |             |          |            |
| Non owner-occupied                  | \$ 126,230 | \$ 6,464        | \$ 18,840   | \$ 0     | \$ 151,534 |
| All other CRE                       | 110,365    | 9,072           | 27,880      | 0        | 147,317    |
| Acquisition and development         |            |                 |             |          |            |
| 1-4 family residential construction | 9,284      | 1,101           | 5,967       | 0        | 16,352     |
| All other A&D                       | 79,136     | 1,073           | 31,830      | 0        | 112,039    |
| Commercial and industrial           | 60,234     | 2,029           | 6,750       | 0        | 69,013     |
| Residential mortgage                |            |                 |             |          |            |
| Residential mortgage - term         | 255,993    | 751             | 11,885      | 0        | 268,629    |
| Residential mortgage - home equity  | 75,935     | 195             | 2,160       | 0        | 78,290     |
| Consumer                            | 31,376     | 22              | 257         | 0        | 31,655     |
| Total                               | \$ 748,553 | \$ 20,707       | \$ 105,569  | \$ 0     | \$ 874,829 |

Management further monitors the performance and credit quality of the loan portfolio by analyzing the age of the portfolio as determined by the length of time a recorded payment is past due. A loan is considered to be past due when a payment has not been received for 30 days past its contractual due date. For all loan segments, the accrual of interest is discontinued when principal or interest is delinquent for 90 days or more unless the loan is well-secured and in the process of collection. All non-accrual loans are considered to be impaired. Interest payments received on non-accrual loans are applied as a reduction of the loan principal balance. Loans are returned to accrual status when all principal and interest amounts contractually due are brought current and future payments are reasonably assured. The Corporation's policy for recognizing interest income on impaired loans does not differ from its overall policy for interest recognition.

The following table presents the classes of the loan portfolio summarized by the aging categories of performing loans and non-accrual loans as of March 31, 2013 and December 31, 2012:

| (in thousands)                         | Current    | 30-59 Days<br>Past Due | 60-89 Days<br>Past Due | 90 Days+<br>Past Due | Total Past<br>Due and<br>Accruing | Non-Accrual | Total Loans |
|--|------------|------------------------|------------------------|----------------------|-----------------------------------|-------------|-------------|
| <b>March 31, 2013</b>                  |            |                        |                        |                      |                                   |             |             |
| Commercial real estate                 |            |                        |                        |                      |                                   |             |             |
| Non owner-occupied                     | \$ 145,725 | \$ 196                 | \$ 172                 | \$ 64                | \$ 432                            | \$ 4,295    | \$ 150,452  |
| All other CRE                          | 137,933    | 140                    | 0                      | 0                    | 140                               | 2,094       | 140,167     |
| Acquisition and development            |            |                        |                        |                      |                                   |             |             |
| 1-4 family residential<br>construction | 13,719     | 0                      | 0                      | 0                    | 0                                 | 1,541       | 15,260      |
| All other A&D                          | 95,480     | 2,410                  | 0                      | 0                    | 2,410                             | 10,992      | 108,882     |
| Commercial and industrial              | 67,793     | 259                    | 101                    | 41                   | 401                               | 186         | 68,380      |
| Residential mortgage                   |            |                        |                        |                      |                                   |             |             |
| Residential mortgage - term            | 257,615    | 10,643                 | 743                    | 160                  | 11,546                            | 3,213       | 272,374     |
| Residential mortgage - home<br>equity  | 75,485     | 753                    | 231                    | 0                    | 984                               | 136         | 76,605      |
| Consumer                               | 26,623     | 593                    | 177                    | 41                   | 811                               | 115         | 27,549      |
| Total                                  | \$ 820,373 | \$ 14,994              | \$ 1,424               | \$ 306               | \$ 16,724                         | \$ 22,572   | \$ 859,669  |
| <b>December 31, 2012</b>               |            |                        |                        |                      |                                   |             |             |
| Commercial real estate                 |            |                        |                        |                      |                                   |             |             |
| Non owner-occupied                     | \$ 146,796 | \$ 321                 | \$ 64                  | \$ 0                 | \$ 385                            | \$ 4,353    | \$ 151,534  |
| All other CRE                          | 143,108    | 2,368                  | 0                      | 0                    | 2,368                             | 1,841       | 147,317     |
| Acquisition and development            |            |                        |                        |                      |                                   |             |             |
| 1-4 family residential<br>construction | 16,280     | 61                     | 0                      | 0                    | 61                                | 11          | 16,352      |
| All other A&D                          | 100,232    | 619                    | 221                    | 200                  | 1,040                             | 10,767      | 112,039     |
| Commercial and industrial              | 68,228     | 580                    | 29                     | 0                    | 609                               | 176         | 69,013      |
| Residential mortgage                   |            |                        |                        |                      |                                   |             |             |
| Residential mortgage - term            | 251,673    | 7,446                  | 5,244                  | 1,639                | 14,329                            | 2,627       | 268,629     |
| Residential mortgage - home<br>equity  | 77,224     | 583                    | 130                    | 249                  | 962                               | 104         | 78,290      |
| Consumer                               | 30,434     | 800                    | 327                    | 58                   | 1,185                             | 36          | 31,655      |
| Total                                  | \$ 833,975 | \$ 12,778              | \$ 6,015               | \$ 2,146             | \$ 20,939                         | \$ 19,915   | \$ 874,829  |

Non-accrual loans which have been subject to a partial charge-off totaled \$6.6 million as of March 31, 2013, compared to \$6.7 million as of December 31, 2012.

An allowance for loan losses (“ALL”) is maintained to absorb losses from the loan portfolio. The ALL is based on management’s continuing evaluation of the risk characteristics and credit quality of the loan portfolio, assessment of current economic conditions, diversification and size of the portfolio, adequacy of collateral, past and anticipated loss

experience, and the amount of non-performing loans.

The Bank's methodology for determining the ALL is based on the requirements of ASC Section 310-10-35, *Receivables-Overall-Subsequent Measurement*, for loans individually evaluated for impairment and ASC Subtopic 450-20, *Contingencies-Loss Contingencies*, for loans collectively evaluated for impairment, as well as the Interagency Policy Statement on the Allowance for Loan and Lease Losses and other bank regulatory guidance. The total of the two components represents the Bank's ALL.

The following table summarizes the primary segments of the ALL, segregated by the amount required for loans individually evaluated for impairment and the amount required for loans collectively evaluated for impairment as of March 31, 2013 and December 31, 2012.

| (in thousands)                        | Commercial Real Estate | Acquisition and Development | Commercial and Industrial | Residential Mortgage | Consumer | Total    |
|---------------------------------------|------------------------|-----------------------------|---------------------------|----------------------|----------|----------|
| March 31, 2013                        |                        |                             |                           |                      |          |          |
| Total ALL                             | \$ 5,789               | \$ 4,760                    | \$ 645                    | \$ 4,483             | \$ 348   | \$16,025 |
| Individually evaluated for impairment | \$ 209                 | \$ 2,366                    | \$ 128                    | \$ 78                | \$ 0     | \$2,781  |
| Collectively evaluated for impairment | \$ 5,580               | \$ 2,394                    | \$ 517                    | \$ 4,405             | \$ 348   | \$13,244 |
| December 31, 2012                     |                        |                             |                           |                      |          |          |
| Total ALL                             | \$ 5,206               | \$ 5,029                    | \$ 906                    | \$ 4,507             | \$ 399   | \$16,047 |
| Individually evaluated for impairment | \$ 126                 | \$ 1,506                    | \$ 0                      | \$ 0                 | \$ 0     | \$1,632  |
| Collectively evaluated for impairment | \$ 5,080               | \$ 3,523                    | \$ 906                    | \$ 4,507             | \$ 399   | \$14,415 |

Management evaluates individual loans in all of the commercial segments for possible impairment, if the loan is greater than \$500,000 or is part of a relationship that is greater than \$750,000 and is either (a) in nonaccrual status or (b) risk-rated Substandard and greater than 60 days past due. Loans are considered to be impaired when, based on current information and events, it is probable that the Bank will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in evaluating impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. The Bank does not separately evaluate individual consumer and residential mortgage loans for impairment, unless such loans are part of a larger relationship that is impaired; otherwise loans in these segments are considered impaired when they are classified as non-accrual.

Once the determination has been made that a loan is impaired, the determination of whether a specific allocation of the allowance is necessary is measured by comparing the recorded investment in the loan to the fair value of the loan using one of three methods: (a) the present value of expected future cash flows discounted at the loan's effective interest rate; (b) the loan's observable market price; or (c) the fair value of the collateral less selling costs. The method is selected on a loan-by-loan basis, with management primarily utilizing the fair value of collateral method. If the fair value of the collateral less selling costs method is utilized for collateral securing loans in the commercial segments, then an updated external appraisal is ordered on the collateral supporting the loan if the loan balance is greater than \$500,000 and the existing appraisal is greater than 18 months old. If an appraisal is less than 12 months old (the age at which the internal appraisal grid begins) and if management believes that general market conditions in that geographic market have changed considerably, the property has deteriorated or perhaps lost an income stream, or a recent

appraisal for a similar property indicates a significant change, then management may adjust the fair value indicated by the existing appraisal until a new appraisal is obtained. If the most recent appraisal is greater than 12 months old or if an updated appraisal has not been received and reviewed in time for the determination of estimated fair value at quarter (or year) end, then the estimated fair value of the collateral is determined by adjusting the existing appraisal by the appropriate percentage from an internally prepared appraisal discount grid. This grid considers the age of a third party appraisal and the geographic region where the collateral is located in order to discount an appraisal that is greater than 12 months old. The discount rates in the appraisal discount grid are updated quarterly to reflect the most current knowledge that management has available, including the results of current appraisals. If there is a delay in receiving an updated appraisal or if the appraisal is found to be deficient in our internal appraisal review process and re-ordered, then the Bank continues to use a discount factor from the appraisal discount grid based on the collateral location and current appraisal age in order to determine the estimated fair value. A specific allocation of the ALL is recorded if there is any deficiency in collateral value determined by comparing the estimated fair value to the recorded investment of the loan. When updated appraisals are received and reviewed, adjustments are made to the specific allocation as needed.

The evaluation of the need and amount of a specific allocation of the ALL and whether a loan can be removed from impairment status is made on a quarterly basis.

The following table presents impaired loans by class, segregated by those for which a specific allowance was required and those for which a specific allowance was not necessary as of March 31, 2013 and December 31, 2012:

| (in thousands)                      | Impaired Loans with Specific Allowance |                    | Impaired Loans with No Specific Allowance | Total Impaired Loans |                          |
|-------------------------------------|--|--------------------|---|----------------------|--------------------------|
|                                     | Recorded Investment                    | Related Allowances | Recorded Investment                       | Recorded Investment  | Unpaid Principal Balance |
| March 31, 2013                      |  |                    |   |                      |                          |
| Commercial real estate              |  |                    |   |                      |                          |
| Non owner-occupied                  | \$ 135                                 | \$ 27              | \$ 5,103                                  | \$ 5,238             | \$ 7,868                 |
| All other CRE                       | 985                                    | 182                | 9,767                                     | 10,752               | 10,905                   |
| Acquisition and development         |  |                    |   |                      |                          |
| 1-4 family residential construction | 3,584                                  | 625                | 9   | 3,593                | 3,681                    |
| All other A&D                       | 5,383                                  | 1,741              | 15,266                                    | 20,649               | 24,898                   |
| Commercial and industrial           | 128                                    | 128                | 3,287                                     | 3,415                | 3,432                    |
| Residential mortgage                |  |                    |   |                      |                          |
| Residential mortgage - term         | 706                                    | 78                 | 3,433                                     | 4,139                | 4,855                    |
| Residential mortgage – home equity  | 0                                      | 0                  | 597                                       | 597                  | 597                      |
| Consumer                            | 0                                      | 0                  | 116                                       | 116                  | 116                      |
| Total impaired loans                | \$ 10,921                              | \$ 2,781           | \$ 37,578                                 | \$ 48,499            | \$ 56,352                |
| December 31, 2012                   |  |                    |   |                      |                          |
| Commercial real estate              |  |                    |   |                      |                          |
| Non owner-occupied                  | \$ 0                                   | \$ 0               | \$ 5,309                                  | \$ 5,309             | \$ 7,929                 |
| All other CRE                       | 1,019                                  | 126                | 9,613                                     | 10,632               | 10,785                   |
| Acquisition and development         |  |                    |   |                      |                          |
| 1-4 family residential construction | 2,052                                  | 471                | 10  | 2,062                | 2,062                    |
| All other A&D                       | 5,410                                  | 1,035              | 16,640                                    | 22,050               | 26,232                   |
| Commercial and industrial           | 0                                      | 0                  | 3,449                                     | 3,449                | 3,449                    |
| Residential mortgage                |  |                    |   |                      |                          |
| Residential mortgage - term         | 0                                      | 0                  | 3,755                                     | 3,755                | 4,086                    |
| Residential mortgage – home equity  | 0                                      | 0                  | 549                                       | 549                  | 549                      |
| Consumer                            | 0                                      | 0                  | 36  | 36                   | 36                       |
| Total impaired loans                | \$ 8,481                               | \$ 1,632           | \$ 39,361                                 | \$ 47,842            | \$ 55,128                |

Loans that are collectively evaluated for impairment are analyzed with general allowances being made as appropriate. For general allowances, historical loss trends are used in the estimation of losses in the current portfolio. These historical loss amounts are modified by other qualitative factors.

The classes described above, which are based on the Federal call code assigned to each loan, provide the starting point for the ALL analysis. Management tracks the historical net charge-off activity (full and partial charge-offs, net of full and partial recoveries) at the call code level. A historical charge-off factor is calculated utilizing a defined number of consecutive historical quarters. Consumer pools currently utilize a rolling 12 quarters, while Commercial pools currently utilize a rolling eight quarters.



“Pass” rated credits are segregated from “Criticized” credits for the application of qualitative factors. The un-criticized (“pass”) pools for commercial and residential real estate are further segmented based upon the geographic location of the underlying collateral. There are seven geographic regions utilized – six that represent the Bank’s lending footprint and a seventh for all out-of-market credits. Different economic environments and resultant credit risks exist in each region that are acknowledged in the assignment of qualitative factors. Loans in the criticized pools, which possess certain qualities or characteristics that may lead to collection and loss issues, are closely monitored by management and subject to additional qualitative factors.

Management supplements the historical charge-off factor with a number of additional qualitative factors that are likely to cause estimated credit losses associated with the existing loan pools to differ from historical loss experience. The additional factors, which are evaluated quarterly and updated using information obtained from internal, regulatory, and governmental sources, are: (a) national and local economic trends and conditions; (b) levels of and trends in delinquency rates and non-accrual loans; (c) trends in volumes and terms of loans; (d) effects of changes in lending policies; (e) experience, ability, and depth of lending staff; (f) value of underlying collateral; and (g) concentrations of credit from a loan type, industry and/or geographic standpoint.

Management reviews the loan portfolio on a quarterly basis using a defined, consistently applied process in order to make appropriate and timely adjustments to the ALL. When information confirms all or part of specific loans to be uncollectible, these amounts are promptly charged off against the ALL. Residential mortgage and consumer loans are charged off after they are 120 days contractually past due. All other loans are charged off based on an evaluation of the facts and circumstances of each individual loan. When the Bank believes that its ability to collect is solely dependent on the liquidation of the collateral, a full or partial charge-off is recorded promptly to bring the recorded investment to an amount that the Bank believes is supported by an ability to collect on the collateral. The circumstances that may impact the Bank’s decision to charge-off all or a portion of a loan include default or non-payment by the borrower, scheduled foreclosure actions, and/or prioritization of the Bank’s claim in bankruptcy. There may be circumstances where, due to pending events, the Bank will place a specific allocation of the ALL on a loan for which a partial charge-off has been previously recognized. This specific allocation may be either charged off or removed depending upon the outcome of the pending event. Full or partial charge-offs are not recovered until full principal and interest on the loan have been collected, even if a subsequent appraisal supports a higher value. Loans with partial charge-offs remain in non-accrual status. Both full and partial charge-offs reduce the recorded investment of the loan and the ALL and are considered to be charge-offs for purposes of all credit loss metrics and trends, including the historical rolling charge-off rates used in the determination of the ALL.

Activity in the ALL is presented for the three-months ended March 31, 2013 and March 31, 2012:

| (in thousands)                 | Commercial<br>Real Estate | Acquisition and<br>Development | Commercial<br>and Industrial | Residential<br>Mortgage | Consumer | Total    |
|--------------------------------|---------------------------|--------------------------------|------------------------------|-------------------------|----------|----------|
| ALL balance at January 1, 2013 | \$ 5,206                  | \$ 5,029                       | \$ 906                       | \$ 4,507                | \$ 399   | \$16,047 |
| Charge-offs                    | 0                         | (4                             | ) (876                       | ) (155                  | ) (143   | ) (1,178 |
| Recoveries                     | 100                       | 8                              | 49                           | 31                      | 103      | 291      |

Edgar Filing: FIRST UNITED CORP/MD/ - Form 10-Q

|                                |          |          |      |          |          |        |      |          |      |   |          |
|--------------------------------|----------|----------|------|----------|----------|--------|------|----------|------|---|----------|
| Provision                      | 483      | (273     | )    | 566      | 100      | (11    | )    | 865      |      |   |          |
| ALL balance at March 31, 2013  | \$ 5,789 | \$ 4,760 |      | \$ 645   | \$ 4,483 | \$ 348 |      | \$16,025 |      |   |          |
| ALL balance at January 1, 2012 | \$ 6,218 | \$ 7,190 |      | \$ 2,190 | \$ 3,430 | \$ 452 |      | \$19,480 |      |   |          |
| Charge-offs                    | (1,161   | )        | (246 | )        | (9,091   | )      | (283 | )        | (173 | ) | (10,954) |
| Recoveries                     | 0        | 12       |      | 330      | 99       | 122    |      | 563      |      |   |          |
| Provision                      | 1,578    | (1,077   | )    | 7,500    | 131      | (8     | )    | 8,124    |      |   |          |
| ALL balance at March 31, 2012  | \$ 6,635 | \$ 5,879 |      | \$ 929   | \$ 3,377 | \$ 393 |      | \$17,213 |      |   |          |

The ALL is based on estimates, and actual losses may vary from current estimates. Management believes that the granularity of the homogeneous pools and the related historical loss ratios and other qualitative factors, as well as the consistency in the application of assumptions, result in an ALL that is representative of the risk found in the components of the portfolio at any given date.

The following tables present the average recorded investment in impaired loans by class and related interest income recognized for the periods indicated:

| (in thousands)                      | Three months ended<br>March 31, 2013 |  |  | Three months ended<br>March 31, 2012 |  |  |
|-------------------------------------|--------------------------------------|--|--|--------------------------------------|--|--|
|                                     | Average<br>investment                | Interest<br>income<br>recognized<br>on an<br>accrual basis | Interest<br>income<br>recognized<br>on a cash<br>basis | Average<br>investment                | Interest<br>income<br>recognized<br>on an<br>accrual basis | Interest<br>income<br>recognized<br>on a cash<br>basis |
| Commercial real estate              |                                      |  |  |                                      |  |  |
| Non owner-occupied                  | \$5,274                              | \$ 12  | \$ 0   | \$8,899                              | \$ 6   | \$ 0   |
| All other CRE                       | 10,692                               | 89   | 46   | 8,136                                | 80   | 0  |
| Acquisition and development         |                                      |  |  |                                      |  |  |
| 1-4 family residential construction | 2,828                                | 24   | 0  | 2,463                                | 24   | 0  |
| All other A&D                       | 21,350                               | 142  | 0  | 23,124                               | 105  | 0  |
| Commercial and industrial           | 3,432                                | 35   | 0  | 8,514                                | 34   | 0  |
| Residential mortgage                |                                      |  |  |                                      |  |  |
| Residential mortgage - term         | 3,947                                | 19   | 2  | 4,994                                | 35   | 15   |
| Residential mortgage – home equity  | 573                                  | 6  | 0  | 1,056                                | 4  | 3  |
| Consumer                            | 76                                   | 0  | 0  | 49                                   | 0  | 0  |
| Total                               | \$48,172                             | \$ 327   | \$ 48  | \$57,235                             | \$ 288   | \$ 18  |

In the normal course of business, the Bank modifies loan terms for various reasons. These reasons may include as a retention strategy, remaining competitive in the current interest rate environment, and re-amortizing or extending a loan term to better match the loan's payment stream with the borrower's cash flows. A modified loan is considered to be a troubled debt restructuring ("TDR") when the Bank has determined that the borrower is troubled (i.e. experiencing financial difficulties). The Bank evaluates the probability that the borrower will be in payment default on any of its debt obligations in the foreseeable future without modification. To make this determination, the Bank performs a global financial review of the borrower and loan guarantors to assess their current ability to meet their financial obligations.

When the Bank restructures a loan to a troubled borrower, the loan terms (i.e., interest rate, payment amount, amortization period, and/or maturity date) are modified in such a way as to enable the borrower to cover the modified debt service payments based on current financials and cash flow adequacy. If a borrower's hardship is thought to be temporary, then modified terms are only offered for that time period. Where possible, the Bank obtains additional collateral and/or secondary payment sources at the time of the restructure in order to put the Bank in the best possible position if the borrower is not able to meet the modified terms. To date, the Bank has not forgiven any principal as a restructuring concession. The Bank will not offer modified terms if it believes that modifying the loan terms will only delay an inevitable permanent default.

All loans designated as TDRs are considered impaired loans and may be in either accruing or non-accruing status. The Corporation's policy for recognizing interest income on impaired loans does not differ from its overall policy for interest recognition. Accordingly, the accrual of interest is discontinued when principal or interest is delinquent for 90 days or more unless the loan is well-secured and in the process of collection. If the loan was accruing at the time of the modification, then it continues to be in accruing status subsequent to the modification. Non-accrual TDRs may return to accruing status when there has been sufficient payment performance for a period of at least six months. Loans may be removed from TDR status in the calendar year following the modification if the interest rate at the time of modification was consistent with the interest rate for a loan with comparable credit risk and the loan has performed according to its modified terms for at least six months.

The volume and type of TDR activity is considered in the assessment of the local economic trends' qualitative factor used in the determination of the ALL for loans that are evaluated collectively for impairment.

The following table presents the volume and recorded investment at the time of modification of TDRs by class and type of modification that occurred during the periods indicated:

| (in thousands)                      | Temporary Rate<br>Modification |                        | Extension of Maturity     |                        | Modification of Payment<br>and Other Terms |                        |
|-------------------------------------|--------------------------------|------------------------|---------------------------|------------------------|--|------------------------|
|                                     | Number<br>of<br>Contracts      | Recorded<br>Investment | Number<br>of<br>Contracts | Recorded<br>Investment | Number<br>of<br>Contracts                  | Recorded<br>Investment |
| Three months ended March 31, 2013   |                                |                        |                           |                        |  |                        |
| Commercial real estate              |                                |                        |                           |                        |  |                        |
| Non owner-occupied                  | 0                              | \$ 0                   | 2                         | \$ 268                 | 0  | \$ 0                   |
| All other CRE                       | 0                              | 0                      | 0                         | 0                      | 0  | 0                      |
| Acquisition and development         |                                |                        |                           |                        |  |                        |
| 1-4 family residential construction | 0                              | 0                      | 0                         | 0                      | 0  | 0                      |
| All other A&D                       | 0                              | 0                      | 2                         | 252                    | 0  | 0                      |
| Commercial and industrial           | 0                              | 0                      | 0                         | 0                      | 0  | 0                      |
| Residential mortgage                |                                |                        |                           |                        |  |                        |
| Residential mortgage – term         | 1                              | 172                    | 0                         | 0                      | 0  | 0                      |
| Residential mortgage – home equity  | 0                              | 0                      | 0                         | 0                      | 0  | 0                      |
| Consumer                            | 0                              | 0                      | 0                         | 0                      | 0  | 0                      |
| Total                               | 1                              | \$ 172                 | 4                         | \$ 520                 | 0  | \$ 0                   |

| (in thousands)                      | Temporary Rate<br>Modification |                        | Extension of Maturity     |                        | Modification of Payment<br>and Other Terms |                        |
|-------------------------------------|--------------------------------|------------------------|---------------------------|------------------------|--|------------------------|
|                                     | Number<br>of<br>Contracts      | Recorded<br>Investment | Number<br>of<br>Contracts | Recorded<br>Investment | Number<br>of<br>Contracts                  | Recorded<br>Investment |
| Three Months Ended March 31, 2012   |                                |                        |                           |                        |  |                        |
| Commercial real estate              |                                |                        |                           |                        |  |                        |
| Non owner-occupied                  | 0                              | \$ 0                   | 0                         | \$ 0                   | 0  | \$ 0                   |
| All other CRE                       | 0                              | 0                      | 0                         | 0                      | 0  | 0                      |
| Acquisition and development         |                                |                        |                           |                        |  |                        |
| 1-4 family residential construction | 0                              | 0                      | 0                         | 0                      | 0  | 0                      |
| All other A&D                       | 0                              | 0                      | 0                         | 0                      | 0  | 0                      |
| Commercial and industrial           | 0                              | 0                      | 0                         | 0                      | 0  | 0                      |
| Residential mortgage                |                                |                        |                           |                        |  |                        |
| Residential mortgage – term         | 1                              | 513                    | 0                         | 0                      | 0  | 0                      |
| Residential mortgage – home equity  | 0                              | 0                      | 0                         | 0                      | 0  | 0                      |
| Consumer                            | 0                              | 0                      | 0                         | 0                      | 0  | 0                      |
| Total                               | 1                              | \$ 513                 | 0                         | \$ 0                   | 0  | \$ 0                   |

During the three months ended March 31, 2013, there were three new TDRs. In addition, two existing TDRs which had reached their original modification maturity were re-modified. An \$11,266 reduction of the ALL resulted from the movement of the three new loans being evaluated collectively for impairment to being evaluated individually for impairment. There was no impact to the recorded investment relating to the transfer of these loans. There was one new TDR with a temporary rate modification during the three months ended March 31, 2012 for which there was no impact to the recorded investment and a \$4,300 reduction of the ALL resulting from the movement of the loan being evaluated collectively for impairment to being evaluated individually for impairment. During the quarters ended March 31, 2013 and March 31, 2012, there were no receivables modified as troubled debt restructurings within the previous 12 months for which there was a payment default during the periods indicated.

#### **Note 8 – Fair Value of Financial Instruments**

The Corporation complies with the guidance of ASC Topic 820, *Fair Value Measurements and Disclosures*, which defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements required under other accounting pronouncements. The Corporation also follows the guidance on matters relating to all financial instruments found in ASC Subtopic 825-10, *Financial Instruments – Overall*.

Fair value is defined as the price to sell an asset or to transfer a liability in an orderly transaction between willing market participants as of the measurement date. Fair value is best determined by values quoted through active trading markets. Active trading markets are characterized by numerous transactions of similar financial instruments between willing buyers and willing sellers. Because no active trading market exists for various types of financial instruments, many of the fair values disclosed were derived using present value discounted cash flows or other valuation techniques described below. As a result, the Corporation's ability to actually realize these derived values cannot be assumed.

The Corporation measures fair values based on the fair value hierarchy established in ASC Paragraph 820-10-35-37. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). The three levels of inputs that may be used to measure fair value under the hierarchy are as follows:

*Level 1:* Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets and liabilities. This level is the most reliable source of valuation.

*Level 2:* Quoted prices that are not active, or inputs that are observable either directly or indirectly, for substantially the full term of the asset or liability. Level 2 inputs include inputs other than quoted prices that are observable for the asset or liability (for example, interest rates and yield curves at commonly quoted intervals, volatilities, prepayment speeds, loss severities, credit risks, and default rates). It also includes inputs that are derived principally from or corroborated by observable market data by correlation or other means (market-corroborated inputs). Several sources are utilized for valuing these assets, including a contracted valuation service, Standard & Poor's ("S&P") evaluations and pricing services, and other valuation matrices.

*Level 3:* Prices or valuation techniques that require inputs that are both significant to the valuation assumptions and not readily observable in the market (i.e. supported with little or no market activity). Level 3 instruments are valued based on the best available data, some of which is internally developed, and consider risk premiums that a market participant would require.

The level established within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement.

The Corporation believes that its valuation techniques are appropriate and consistent with the techniques used by other market participants. However, the use of different methodologies and assumptions could result in a different estimate of fair values at the reporting date. The valuation techniques used by the Corporation to measure, on a recurring and non-recurring basis, the fair value of assets as of March 31, 2013 are discussed in the paragraphs that follow.

***Investments*** – The investment portfolio is classified and accounted for based on the guidance of ASC Topic 320, *Investments – Debt and Equity Securities*.

The fair value of investments available-for-sale is determined using a market approach. As of March 31, 2013, the U.S. Government agencies, residential and commercial mortgage-backed securities, and municipal bonds segments

are classified as Level 2 within the valuation hierarchy. Their fair values were determined based upon market-corroborated inputs and valuation matrices, which were obtained through third party data service providers or securities brokers through which the Corporation has historically transacted both purchases and sales of investment securities.

The CDO segment, which consists of pooled trust preferred securities issued by banks, thrifts and insurance companies, is classified as Level 3 within the valuation hierarchy. At March 31, 2013, the Corporation owned 18 pooled trust preferred securities with an amortized cost of \$36.9 million and a fair value of \$13.8 million. The market for these securities at March 31, 2013 is not active and markets for similar securities are also not active. The inactivity was evidenced first by a significant widening of the bid-ask spread in the brokered markets in which these securities trade and then by a significant decrease in the volume of trades relative to historical levels. The new issue market is also inactive, as few CDOs have been issued since 2007. There are currently very few market participants who are willing to effect transactions in these securities. The market values for these securities or any securities other than those issued or guaranteed by the U.S. Department of the Treasury (the "Treasury") are depressed relative to historical levels. Therefore, in the current market, a low market price for a particular bond may only provide evidence of stress in the credit markets in general rather than being an indicator of credit problems with a particular issue. Given the conditions in the current debt markets and the absence of observable transactions in the secondary and new issue markets, management has determined that (a) the few observable transactions and market quotations that are available are not reliable for the purpose of obtaining fair value at March 31, 2013, (b) an income valuation approach technique (i.e. present value) that maximizes the use of relevant observable inputs and minimizes the use of unobservable inputs will be equally or more representative of fair value than a market approach, and (c) the CDO segment is appropriately classified within Level 3 of the valuation hierarchy because management determined that significant adjustments were required to determine fair value at the measurement date.



Management utilizes an independent third party to prepare both the evaluations of other-than-temporary impairment as well as the fair value determinations for its CDO portfolio. Management does not believe that there were any material differences in the impairment evaluations and pricing between March 31, 2013 and December 31, 2012.

The approach of the third party to determine fair value involves several steps, including detailed credit and structural evaluation of each piece of collateral in each bond, default, recovery and prepayment/amortization probabilities for each piece of collateral in the bond, and discounted cash flow modeling. The discount rate methodology used by the third party combines a baseline current market yield for comparable corporate and structured credit products with adjustments based on evaluations of the differences found in structure and risks associated with actual and projected credit performance of each CDO being valued. Currently, the only active and liquid trading market that exists is for stand-alone trust preferred securities. Therefore, adjustments to the baseline discount rate are also made to reflect the additional leverage found in structured instruments.

***Derivative financial instruments (Cash flow hedge)*** – The Corporation’s open derivative positions are interest rate swaps that are classified as Level 3 within the valuation hierarchy. Open derivative positions are valued using externally developed pricing models based on observable market inputs provided by a third party and validated by management. The Corporation has considered counterparty credit risk in the valuation of its interest rate swap assets.

***Impaired loans*** – Loans included in the table below are those that are considered impaired with a specific allocation or with a partial charge-off, based upon the guidance of the loan impairment subsection of the *Receivables* Topic, ASC Section 310-10-35, under which the Corporation has measured impairment generally based on the fair value of the loan’s collateral. Fair value consists of the loan balance less its valuation allowance and is generally determined based on independent third-party appraisals of the collateral or discounted cash flows based upon the expected proceeds. These assets are included as Level 3 fair values based upon the lowest level of input that is significant to the fair value measurements.

***Other real estate owned*** – Other real estate owned included in the table below are considered impaired with specific write-downs. Fair value of other real estate owned is based on independent third-party appraisals of the properties. These values were determined based on the sales prices of similar properties in the approximate geographic area. These assets are included as Level 3 fair values based upon the lowest level of input that is significant to the fair value measurements.

For Level 3 assets and liabilities measured at fair value on a recurring and non-recurring basis as of March 31, 2013, the significant unobservable inputs used in the fair value measurements were as follows:

#### Valuation Technique

Edgar Filing: FIRST UNITED CORP/MD/ - Form 10-Q

|   | Fair Value at<br>March 31, 2013 |                                 | Significant<br>Unobservable<br>Inputs | Significant<br>Unobservable Input<br>Value |
|---|---------------------------------|---------------------------------|---------------------------------------|--|
| Recurring:                                    |                                 |                                 |                                       |  |
| Investment Securities –<br>available for sale | \$ 13,798                       | Discounted Cash Flow            | Discount Rate                         | Swap+19%; Range of<br>Libor+ 9% to 20%     |
| Cash Flow Hedge                               | \$ (748                         | ) Discounted Cash Flow          | Reuters Third Party<br>Market Quote   | 99.9%<br>(weighted avg 99.9%)              |
| Non-recurring:                                |                                 |                                 |                                       |  |
| Impaired Loans                                | \$ 14,763                       | Market Comparable<br>Properties | Marketability<br>Discount             | 10% (1)<br>(weighted avg 10%)              |
| OREO  | \$ 38                           | Market Comparable<br>Properties | Marketability<br>Discount             | 10% (1)<br>(weighted avg 10%)              |

(1) Range would include discounts taken since appraisal and estimated values

For assets measured at fair value on a recurring and non-recurring basis, the fair value measurements by level within the fair value hierarchy used at March 31, 2013 and December 31, 2012 are as follows:

| Description                                      | Assets Measured at Fair Value | Fair Value Measurements at March 31, 2013 Using (In Thousands) |   |
|--|-------------------------------|--|---|
|  |                               | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) |
|  | 3/31/2013                     |  | Significant Unobservable Inputs (Level 3)     |
| Recurring:                                       |                               |  |   |
| Investment securities available-for-sale:        |                               |  |   |
| U.S. government agencies                         | \$ 47,228                     | \$ 47,228  |   |
| Residential mortgage-backed agencies             | \$ 81,418                     | \$ 81,418  |   |
| Commercial mortgage-backed agencies              | \$ 15,026                     | \$ 15,026  |   |
| Collateralized mortgage obligations              | \$ 23,279                     | \$ 23,279  |   |
| Obligations of states and political subdivisions | \$ 58,691                     | \$ 58,691  |   |
| Collateralized debt obligations                  | \$ 13,798                     |  | \$ 13,798                                     |
| Financial Derivative                             | \$ (748 )                     |  | \$ (748 )                                     |
| Non-recurring:                                   |                               |  |   |
| Impaired loans                                   | \$ 14,763                     |  | \$ 14,763                                     |
| Other real estate owned                          | \$ 38                         |  | \$ 38   |

| Description                                      | Assets Measured at Fair Value | Fair Value Measurements at December 31, 2012 Using (In Thousands) |   |
|--|-------------------------------|---|---|
|  |                               | Quoted Prices in Active Markets for Identical Assets (Level 1)    | Significant Other Observable Inputs (Level 2) |
|  | 12/31/2012                    |   | Significant Unobservable Inputs (Level 3)     |
| Recurring:                                       |                               |   |   |
| Investment securities available-for-sale:        |                               |   |   |
| U.S. government agencies                         | \$ 40,320                     | \$ 40,320   |   |
| Residential mortgage-backed agencies             | \$ 44,108                     | \$ 44,108   |   |
| Commercial mortgage-backed agencies              | \$ 37,618                     | \$ 37,618   |   |
| Collateralized mortgage obligations              | \$ 31,731                     | \$ 31,731   |   |
| Obligations of states and political subdivisions | \$ 58,054                     | \$ 58,054   |   |
| Collateralized debt obligations                  | \$ 11,442                     |   | \$ 11,442                                     |
| Financial Derivative                             | \$ (849 )                     |   | \$ (849 )                                     |
| Non-recurring:                                   |                               |   |   |

Edgar Filing: FIRST UNITED CORP/MD/ - Form 10-Q

|                         |           |           |
|-------------------------|-----------|-----------|
| Impaired loans          | \$ 13,560 | \$ 13,560 |
| Other real estate owned | \$ 3,165  | \$ 3,165  |

There were no transfers of assets between any of the fair value hierarchy for the three months ended March 31, 2013 or March 31, 2012.

The following tables show a reconciliation of the beginning and ending balances for fair valued assets measured on a recurring basis using Level 3 significant unobservable inputs for the three months ended March 31, 2013 and 2012:

|  | Fair Value Measurements Using Significant Unobservable Inputs<br>(Level 3)<br>(In Thousands) |                 |
|--|--|-----------------|
|  | Investment Securities Available for Sale   | Cash Flow Hedge |
| Beginning balance January 1, 2013      | \$ 11,442  | \$ (849 )       |
| Total gains realized/unrealized:       |  |                 |
| Included in other comprehensive income | 2,356  | 101             |
| Ending balance March 31, 2013          | \$ 13,798  | \$ (748 )       |

The amount of total gains or losses for the period included in earnings attributable to the change in realized/unrealized gains or losses related to assets still held at the reporting date

|      |      |
|------|------|
| \$ 0 | \$ 0 |
|------|------|

|  | Fair Value Measurements Using Significant Unobservable Inputs<br>(Level 3)<br>(In Thousands) |                 |
|--|--|-----------------|
|  | Investment Securities Available for Sale   | Cash Flow Hedge |
| Beginning balance January 1, 2012      | \$ 9,447   | \$ (1,034 )     |
| Total gains realized/unrealized:       |  |                 |
| Included in other comprehensive income | 507  | 46              |
| Ending balance March 31, 2012          | \$ 9,954   | \$ (988 )       |

The amount of total gains or losses for the period included in earnings attributable to the change in realized/unrealized gains or losses related to assets still held at the reporting date

|      |      |
|------|------|
| \$ 0 | \$ 0 |
|------|------|

Gains and losses (realized and unrealized) included in earnings for the periods above are reported in the Consolidated Statement of Operations in Other Operating Income.

The fair values disclosed may vary significantly between institutions based on the estimates and assumptions used in the various valuation methodologies. The derived fair values are subjective in nature and involve uncertainties and significant judgment. Therefore, they cannot be determined with precision. Changes in the assumptions could significantly impact the derived estimates of fair value. Disclosure of non-financial assets such as buildings as well as certain financial instruments such as leases is not required. Accordingly, the aggregate fair values presented do not represent the underlying value of the Corporation.

The following methods and assumptions were used by the Corporation to estimate its fair value disclosures for financial instruments:

***Cash and due from banks:*** The carrying amounts as reported in the statement of financial condition for cash and due from banks approximate their fair values.

***Interest bearing deposits in banks:*** The carrying amount of interest bearing deposits approximates their fair values.

***Securities held to maturity:*** Investments in debt securities classified as held to maturity are measured subsequently at amortized cost in the statement of financial position. These assets are included as Level 3 fair values based upon the lowest level of input that is significant to the fair value measurements.

***Restricted Investment in Bank stock:*** The carrying value of stock issued by the FHLB of Atlanta, ACBB and CBB approximates fair value based on the redemption provisions of the stock.

***Loans (excluding impaired loans with specific loss allowances):*** For variable-rate loans that re-price frequently or “in one year or less”, and with no significant change in credit risk, fair values are based on carrying values. Fair values for fixed-rate loans that do not re-price frequently are estimated using a discounted cash flow calculation that applies current market interest rates being offered on the various loan products.

***Deposits:*** The fair values disclosed for demand deposits (e.g., interest and non-interest checking, savings, and certain types of money market accounts, etc.) are, by definition, equal to the amount payable on demand at the reporting date (i.e., their carrying amounts). Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered on the various certificates of deposit to the cash flow stream.

***Borrowed funds:*** The fair value of the Bank's FHLB borrowings and junior subordinated debt is calculated based on the discounted value of contractual cash flows, using rates currently existing for borrowings with similar remaining maturities. The carrying amounts of federal funds purchased and securities sold under agreements to repurchase approximate their fair values.

***Accrued Interest:*** The carrying amount of accrued interest receivable and payable approximates their fair values.

***Off-Balance-Sheet Financial Instruments:*** In the normal course of business, the Bank makes commitments to extend credit and issues standby letters of credit. The Bank expects most of these commitments to expire without being drawn upon; therefore, the commitment amounts do not necessarily represent future cash requirements. Due to the uncertainty of cash flows and difficulty in the predicting the timing of such cash flows, fair values were not estimated for these instruments.



The following tables present fair value information about financial instruments, whether or not recognized in the Consolidated Statement of Financial Condition, for which it is practicable to estimate that value. The actual carrying amounts and estimated fair values of the Corporation's financial instruments that are included in the Consolidated Statement of Financial Condition are as follows:

|   | March 31, 2013  |            | Fair Value Measurements  |   |   |
|---|-----------------|------------|--|---|---|
|   | Carrying Amount | Fair Value | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| (in thousands)                          |                 |            |  |   |   |
| <b>Financial Assets:</b>                |                 |            |  |   |   |
| Cash and due from banks                 | \$71,592        | \$71,592   | \$71,592   |   |   |
| Interest bearing deposits in banks      | 13,236          | 13,236     | 13,236   |   |   |
| Investment securities - AFS             | 239,440         | 239,440    |  | \$ 225,642                                    | \$ 13,798                                 |
| Investment securities - HTM             | 4,040           | 4,318      |  |   | 4,318                                     |
| Restricted Bank stock                   | 7,853           | 7,853      |  | 7,853   |   |
| Loans, net                              | 843,644         | 849,518    |  |   | 849,518                                   |
| Accrued interest receivable             | 4,059           | 4,059      |  | 4,059   |   |
| <b>Financial Liabilities:</b>           |                 |            |  |   |   |
| Deposits – non-maturity                 | 611,585         | 574,093    |  | 574,093                                       |   |
| Deposits – time deposits                | 364,215         | 372,857    |  | 372,857                                       |   |
| Short-term borrowed funds               | 38,633          | 38,633     |  | 38,633  |   |
| Long-term borrowed funds                | 182,720         | 190,311    |  | 190,311                                       |   |
| Accrued interest payable                | 5,881           | 5,881      |  | 5,881   |   |
| Financial derivative                    | 748             | 748        |  |   | 748                                       |
| Off balance sheet financial instruments | 0               | 0          | 0  |   |   |

|   | December 31, 2012 |            | Fair Value Measurements  |   |   |
|---|-------------------|------------|--|---|---|
|   | Carrying Amount   | Fair Value | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| (in thousands)                          |                   |            |  |   |   |
| <b>Financial Assets:</b>                |                   |            |  |   |   |
| Cash and due from banks                 | \$71,290          | \$71,290   | \$71,290   |   |   |
| Interest bearing deposits in banks      | 11,778            | 11,778     | 11,778   |   |   |
| Investment securities - AFS             | 223,273           | 223,273    |  | \$ 211,831                                    | \$ 11,442                                 |
| Investment securities - HTM             | 4,040             | 4,347      |  |   | 4,347                                     |
| Restricted Bank stock                   | 8,349             | 8,349      |  | 8,349   |   |
| Loans, net                              | 858,782           | 865,405    |  |   | 865,405                                   |
| Accrued interest receivable             | 4,494             | 4,494      |  | 4,494   |   |
| <b>Financial Liabilities:</b>           |                   |            |  |   |   |
| Deposits- non-maturity                  | 593,224           | 593,224    |  | 593,224                                       |   |
| Deposits- time deposits                 | 383,660           | 392,155    |  | 392,155                                       |   |
| Short-term borrowed funds               | 39,257            | 39,257     |  | 39,257  |   |
| Long-term borrowed funds                | 182,735           | 190,531    |  | 190,531                                       |   |
| Accrued interest payable                | 5,415             | 5,415      |  | 5,415   |   |
| Financial derivative                    | 849               | 849        |  |   | 849                                       |
| Off balance sheet financial instruments | 0                 | 0          | 0  |   |   |

Loans are measured using a discounted cash flow method. The significant unobservable inputs used in the Level 3 fair value measurements of the Corporation's loans included in the tables above are calculated based on the Corporation's internal new volume rate.

#### Note 9 – Accumulated Other Comprehensive Loss

The following table presents the changes in each component of accumulated other comprehensive loss for the 12 months ended December 31, 2012 and the three months ended March 31, 2013:

| (in thousands)                | Investment securities- with OTTI | Investment securities- all other | Cash Flow Hedge | Pension Plan | SERP      | Total        |
|-------------------------------|----------------------------------|----------------------------------|-----------------|--------------|-----------|--------------|
| Accumulated OCL, net:         |                                  |                                  |                 |              |           |              |
| Balance - January 1, 2012     | \$ (10,572 )                     | \$ (2,633 )                      | \$ (616 )       | \$ (6,945 )  | \$ (196 ) | \$ (20,962 ) |
| Net gain/(loss) during period | 536                              | (333 )                           | 109             | (1,317 )     | 144       | (861 )       |
| Balance - December 31, 2012   | \$ (10,036 )                     | \$ (2,966 )                      | \$ (507 )       | \$ (8,262 )  | \$ (52 )  | \$ (21,823 ) |
|                               | 1,070                            | (116 )                           | 60              | 639          | 0         | 1,653        |

Edgar Filing: FIRST UNITED CORP/MD/ - Form 10-Q

Other comprehensive income before reclassifications

|  |             |             |           |            |          |             |
|--|-------------|-------------|-----------|------------|----------|-------------|
| Amounts reclassified from accumulated other comprehensive income | (75 )       | (149 )      | 0         | 76         | 4        | (144 )      |
| Balance – March 31, 2013   | \$ (9,041 ) | \$ (3,231 ) | \$ (447 ) | \$ (7,547) | \$ (48 ) | \$ (20,314) |

28

The following table presents the components of comprehensive income for the periods ending March 31, 2013 and 2012:

| <b>Components of Comprehensive Income (in thousands)</b> | Before Tax<br>Amount | Tax (Expense)<br>Benefit | Net              |
|--|----------------------|--------------------------|------------------|
| For the period ended March 31, 2013                      |                      |                          |                  |
| Available for sale (AFS) securities with OTTI:           |                      |                          |                  |
| Unrealized holding gains                                 | \$ 1,788             | \$ (718                  | ) \$1,070        |
| Less: accretable yield recognized in income              | 125                  | (50                      | ) 75             |
| Net unrealized gains on investments with OTTI            | 1,663                | (668                     | ) 995            |
| Available for sale securities – all other:               |                      |                          |                  |
| Unrealized holding losses                                | (195                 | ) 79                     | (116 )           |
| Less: gains recognized in income                         | 250                  | (101                     | ) 149            |
| Net unrealized losses on all other AFS securities        | (445                 | ) 180                    | (265 )           |
| Cash flow hedges:  |                      |                          |                  |
| Unrealized holding gains                                 | 101                  | (41                      | ) 60             |
| Pension Plan:  |                      |                          |                  |
| Unrealized net actuarial gain                            | 1,069                | (430                     | ) 639            |
| Less: amortization of unrecognized loss                  | (133                 | ) 53                     | (80 )            |
| Less: amortization of transition asset                   | 10                   | (4                       | ) 6              |
| Less: amortization of prior service costs                | (3                   | ) 1                      | (2 )             |
| Net pension plan liability adjustment                    | 1,195                | (480                     | ) 715            |
| SERP:  |                      |                          |                  |
| Unrealized net actuarial loss                            | 0                    | 0                        | 0                |
| Less: amortization of unrecognized loss                  | (1                   | ) 0                      | (1 )             |
| Less: amortization of prior service costs                | (5                   | ) 2                      | (3 )             |
| Net SERP liability adjustment                            | 6                    | (2                       | ) 4              |
| <b>Other comprehensive income</b>                        | <b>\$ 2,520</b>      | <b>\$ (1,011</b>         | <b>) \$1,509</b> |
| For the period ended March 31, 2012                      |                      |                          |                  |
| Available for sale (AFS) securities with OTTI:           |                      |                          |                  |
| Unrealized holding gains                                 | \$ 440               | \$ (177                  | ) \$263          |
| Less: accretable yield recognized in income              | 112                  | (45                      | ) 67             |
| Net unrealized gains on investments with OTTI            | 328                  | (132                     | ) 196            |
| Available for sale securities – all other:               |                      |                          |                  |
| Unrealized holding gains                                 | 393                  | (158                     | ) 235            |
| Less: gains recognized in income                         | 599                  | (242                     | ) 357            |
| Net unrealized losses on all other AFS securities        | (206                 | ) 84                     | (122 )           |
| Cash flow hedges:  |                      |                          |                  |
| Unrealized holding gains                                 | 46                   | (19                      | ) 27             |

|                                   |        |        |         |
|-----------------------------------|--------|--------|---------|
| <b>Other comprehensive income</b> | \$ 168 | \$ (67 | ) \$101 |
|-----------------------------------|--------|--------|---------|

The following table presents the details of accumulated other comprehensive income components for the period ending March 31, 2013:

| Details of Accumulated Other Comprehensive Income Components (in thousands)           | Amount Reclassified from Accumulated Other Comprehensive Income | Affected Line Item in the Statement Where Net Income is Presented |
|---|---|---|
| Unrealized gains and losses on investment securities with OTTI:                       |   |   |
| Accretable Yield  | \$ 125  | Interest income on taxable investment securities                  |
| Taxes   | (50)  | ) Tax expense   |
|   | \$ 75   | Net of tax  |
| Unrealized gains and losses on available for sale investment securities - all others: |   |   |
| Gains on sales  | \$ 250  | Net gains - other   |
| Taxes   | (101)   | ) Tax expense   |
|   | \$ 149  | Net of tax  |
| Net pension plan liability adjustment:  |   |   |
| Amortization of unrecognized loss   | (133)   | ) Salaries and employee benefits                                  |
| Amortization of transition asset  | 10  | Salaries and employee benefits                                    |
| Amortization of prior service costs   | (3)   | ) Salaries and employee benefits                                  |
| Taxes   | 50  | Tax benefit   |
|   | \$ (76)   | )   |
| Net SERP liability adjustment:  |   |   |
| Amortization of unrecognized loss   | (1)   | ) Salaries and employee benefits                                  |
| Amortization of prior service costs   | (5)   | ) Salaries and employee benefits                                  |
| Taxes   | 2   | Tax benefit   |
|   | \$ (4)  | )   |
| Total reclassifications for the period  | \$ 144  | Net of tax  |

#### Note 10 – Junior Subordinated Debentures and Restrictions on Dividends

First United Corporation is the parent company to three statutory trust subsidiaries - First United Statutory Trust I and First United Statutory Trust II, both of which are Connecticut statutory trusts (“Trust I” and “Trust II”, respectively), and First United Statutory Trust III, a Delaware statutory trust (“Trust III” and, together with Trust I and Trust II, the “Trusts”). The Trusts were formed for the purposes of selling preferred securities to investors and using the proceeds to purchase junior subordinated debentures from First United Corporation (“TPS Debentures”) that would qualify as regulatory capital.

In March 2004, Trust I and Trust II issued preferred securities with an aggregate liquidation amount of \$30.0 million to third-party investors and issued common equity with an aggregate liquidation amount of \$.9 million to First United Corporation. Trust I and Trust II used the proceeds of these offerings to purchase an equal amount of TPS Debentures, as follows:

\$20.6 million—floating rate payable quarterly based on three-month LIBOR plus 275 basis points (3.03% at March 31, 2013), maturing in 2034, became redeemable five years after issuance at First United Corporation's option.

\$10.3 million—floating rate payable quarterly based on three-month LIBOR plus 275 basis points (3.03% at March 31, 2013) maturing in 2034, became redeemable five years after issuance at First United Corporation's option.

In December 2004, First United Corporation issued \$5.0 million of junior subordinated debentures to third-party investors that were not tied to preferred securities. The debentures had a fixed rate of 5.88% for the first five years, payable quarterly, and converted to a floating rate in March 2010 based on the three month LIBOR plus 185 basis points (2.13% at March 31, 2013). The debentures mature in 2015, but became redeemable five years after issuance at First United Corporation's option.

In December 2009, Trust III issued 9.875% fixed-rate preferred securities with an aggregate liquidation amount of approximately \$7.0 million to private investors and issued common securities to First United Corporation with an aggregate liquidation amount of approximately \$.2 million. Trust III used the proceeds of the offering to purchase approximately \$7.2 million of 9.875% fixed-rate TPS Debentures. Interest on these TPS Debentures are payable quarterly, and the TPS Debentures mature in 2040 but are redeemable five years after issuance at First United Corporation's option.

In January 2010, Trust III issued an additional \$3.5 million of 9.875% fixed-rate preferred securities to private investors and issued common securities to First United Corporation with an aggregate liquidation amount of \$.1 million. Trust III used the proceeds of the offering to purchase \$3.6 million of 9.875% fixed-rate TPS Debentures. Interest on these TPS Debentures is payable quarterly, and the TPS Debentures mature in 2040 but are redeemable five years after issuance at First United Corporation's option.

The TPS Debentures issued to each of the Trusts represent the sole assets of that Trust, and payments of the TPS Debentures by First United Corporation are the only sources of cash flow for the Trust. First United Corporation has the right, without triggering a default, to defer interest on all of the TPS Debentures for up to 20 quarterly periods, in which case distributions on the preferred securities will also be deferred. Should this occur, the Corporation may not pay dividends or distributions on, or repurchase, redeem or acquire any shares of its capital stock.

At the request of the Federal Reserve Bank of Richmond (the "Reserve Bank"), First United Corporation elected to defer quarterly interest payments under its TPS Debentures beginning with the payments that were due in March 2011. As of March 31, 2013, this deferral election remained in effect. Cumulative deferred interest on all TPS Debentures was approximately \$4.9 million, which must be paid in full when First United Corporation terminates the deferral of interest payments. Management cannot predict when the deferral will be terminated. First United Corporation's ability to resume quarterly interest payments will depend primarily on our earnings in future periods.



Interest payments on the \$5.0 million junior subordinated debentures that were issued outside of trust preferred securities offerings cannot be, and have not been, deferred.

The terms of First United Corporation's Fixed Rate Cumulative Perpetual Preferred Stock, Series A ("Series A Preferred Stock") call for the payment, if declared by the Board of Directors of First United Corporation, of cash dividends on February 15<sup>th</sup>, May 15<sup>th</sup>, August 15<sup>th</sup> and November 15<sup>th</sup> of each year. On November 15, 2010, at the request of the Reserve Bank, the Board of Directors of First United Corporation voted to suspend quarterly cash dividends on the Series A Preferred Stock beginning with the dividend payment due November 15, 2010. Dividends of \$.4 million per dividend period continue to accrue, and First United Corporation will be required to pay all accrued and unpaid dividends if and when the Board of Directors declares the next quarterly cash dividend. Cumulative deferred dividends on the Series A Preferred Stock was approximately \$4.0 million as of March 31, 2013. Management cannot predict whether or when First United Corporation will resume the payment of quarterly dividends on the Series A Preferred Stock. First United Corporation's ability to pay cash dividends in the future will depend primarily on our earnings in future periods.

In December 2010, in connection with the above-mentioned deferral of dividends on the Series A Preferred Stock, the Board of Directors of First United Corporation voted to suspend the payment of quarterly cash dividends on the common stock starting in 2011.

**Note 11 – Borrowed Funds**

The following is a summary of short-term borrowings with original maturities of less than one year:

| (Dollars in thousands)                              | Three Months Ended<br>March 31, 2013 | Year Ended December<br>31, 2012 |   |   |
|---|--------------------------------------|---------------------------------|---|---|
| Securities sold under agreements to repurchase:     |                                      |                                 |   |   |
| Outstanding at end of period                        | \$ 38,633                            | \$ 39,257                       |   |   |
| Weighted average interest rate at end of period     | 0.14                                 | 0.34                            | % | % |
| Maximum amount outstanding as of any month end      | \$ 38,633                            | \$ 52,367                       |   |   |
| Average amount outstanding                          | \$ 38,465                            | \$ 38,812                       |   |   |
| Approximate weighted average rate during the period | 0.14                                 | 0.34                            | % | % |

At March 31, 2013, the repurchase agreements were secured by \$56.4 million in available-for-sale investment securities.

The following is a summary of long-term borrowings with original maturities exceeding one year:

| (In thousands)  | March 31,<br>2013 | December 31,<br>2012 |
|---|-------------------|----------------------|
| FHLB advances, bearing fixed interest at rates ranging from 1.00% to 3.69% at March 31, 2013            | \$ 135,990        | \$ 136,005           |
| Junior subordinated debt, bearing variable interest rates ranging from 2.13% to 3.03% at March 31, 2013 | 35,929            | 35,929               |
| Junior subordinated debt, bearing fixed interest rate of 9.88% at March 31, 2013                        | 10,801            | 10,801               |
| Total long-term debt  | \$ 182,720        | \$ 182,735           |

At March 31, 2013, the long-term FHLB advances were secured by \$154.2 million in loans and \$ 3.6 million in investment securities.

The contractual maturities of all long-term borrowings are as follows:

Edgar Filing: FIRST UNITED CORP/MD/ - Form 10-Q

|                      | March 31, 2013 |                  | December 31, 2012 |            |
|----------------------|----------------|------------------|-------------------|------------|
|                      | Fixed<br>Rate  | Floating<br>Rate | Total             | Total      |
| Due in 2013          | \$0            | \$0              | \$0               | \$ 0       |
| Due in 2014          | 0              | 0                | 0                 | 0          |
| Due in 2015          | 30,000         | 5,000            | 35,000            | 35,000     |
| Due in 2016          | 0              | 0                | 0                 | 0          |
| Due in 2017          | 0              | 0                | 0                 | 0          |
| Due in 2018          | 70,000         | 0                | 70,000            | 70,000     |
| Thereafter           | 46,791         | 30,929           | 77,720            | 77,735     |
| Total long-term debt | \$146,791      | \$35,929         | \$182,720         | \$ 182,735 |

**Note 12 - Pension and SERP Plans**

The following table presents the components of the net periodic pension plan cost for First United Corporation's Defined Benefit Pension Plan (the "Pension Plan") and the Bank's Supplemental Executive Retirement Plan ("SERP") for the periods indicated:

| Pension<br><br>(In thousands)                    | For the three months ended<br>March 31, |           |
|--|---|-----------|
|  | 2013                                    | 2012      |
| Service cost                                     | \$ 57                                   | \$ 0      |
| Interest cost                                    | 330                                     | 351       |
| Expected return on assets                        | (594 )                                  | (553 )    |
| Amortization of transition asset                 | (10 )                                   | (10 )     |
| Recognized net actuarial loss                    | 133                                     | 100       |
| Amortization of prior service cost               | 3                                       | 3         |
| Net pension credit included in employee benefits | \$ (81 )                                | \$ (109 ) |

| SERP<br><br>(In thousands)                        | For the three months ended<br>March 31, |        |
|---|---|--------|
|   | 2013                                    | 2012   |
| Service cost                                      | \$ 30                                   | \$ 30  |
| Interest cost                                     | 64                                      | 63     |
| Amortization of recognized loss                   | 1                                       | 3      |
| Amortization of prior service cost                | 5                                       | 31     |
| Net pension expense included in employee benefits | \$ 100                                  | \$ 127 |

Effective April 30, 2010, the Pension Plan was amended, resulting in a "soft freeze". The effects of the amendment were to prohibit new entrants into the plan and to cease crediting additional years of service after that date. Effective January 1, 2013, the plan was amended to unfreeze the plan for those employees for whom the sum of (a) their ages, at their closest birthday, plus (b) years of service for vesting purposes equal 80 or greater. The "soft freeze" continues to apply to all other plan participants. Pension benefits for these participants will be managed through discretionary contributions to the 401(k) Profit Sharing Plan. The Corporation anticipates that the plan changes will have a minimal impact on the consolidated financial statements.

The Corporation will assess the need for future annual contributions to the pension plan based upon its funded status and an evaluation of the future benefits to be provided thereunder. The Corporation expects to fund the annual projected benefit payments for the SERP from operations.

**Note 13 - Equity Compensation Plan Information**

At the 2007 Annual Meeting of Shareholders, First United Corporation's shareholders approved the First United Corporation Omnibus Equity Compensation Plan (the "Omnibus Plan"), which authorizes the issuance of up to 185,000 shares of common stock pursuant to the grant of stock options, stock appreciation rights, stock awards, stock units, performance units, dividend equivalents, and other stock-based awards to employees or directors.

On June 18, 2008, the Board of Directors of First United Corporation adopted a Long-Term Incentive Program (the "LTIP"). This program was adopted as a sub-plan of the Omnibus Plan to reward participants for increasing shareholder value, align executive interests with those of shareholders, and serve as a retention tool for key executives. Under the LTIP, participants are granted shares of restricted common stock of First United Corporation. The amount of an award is based on a specified percentage of the participant's salary as of the date of grant. These shares will vest if the Corporation meets or exceeds certain performance thresholds. There were no grants of restricted stock outstanding at March 31, 2013.

The Corporation complies with the provisions of ASC Topic 718, *Compensation-Stock Compensation*, in measuring and disclosing stock compensation cost. The measurement objective in ASC Paragraph 718-10-30-6 requires public companies to measure the cost of employee services received in exchange for an award of equity instruments based on the grant date fair value of the award. The cost is recognized in expense over the period in which an employee is required to provide service in exchange for the award (the vesting period). The performance-related shares granted in connection with the LTIP are expensed ratably from the date that the likelihood of meeting the performance measures is probable through the end of a three year vesting period.

The American Recovery and Reinvestment Act of 2009 (the “Recovery Act”) imposes restrictions on the type and timing of bonuses and incentive compensation that may be accrued for or paid to certain employees of institutions like First United Corporation that participated in Treasury’s Capital Purchase Program. The Recovery Act generally limits bonuses and incentive compensation to grants of long-term restricted stock that, among other requirements, cannot fully vest until the Capital Purchase Program assistance is repaid.

Stock-based awards were made to non-employee directors in May 2012 pursuant to First United Corporation’s director compensation policy. Five thousand dollars of each director’s annual retainer is paid in shares of stock, with the remainder paid in cash. Beginning in 2011, each non-employee director was given the option to receive the remainder of his or her retainer, or any portion thereof, in shares of stock. A total of 16,526 fully-vested shares of common stock were issued to directors in 2012, which had a fair market value of \$5.14 per share. Director stock compensation expense was \$19,153 for the three months ended March 31, 2013 and \$12,795 for the three months ended March 31, 2012.

#### **Note 14 – Letters of Credit and Off Balance Sheet Liabilities**

The Corporation does not issue any guarantees that would require liability recognition or disclosure other than the standby letters of credit issued by the Bank. Standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Generally, the Bank’s letters of credit are issued with expiration dates within one year. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Bank generally holds collateral and/or personal guarantees supporting these commitments. The Bank had \$1.2 million of outstanding standby letters of credit at March 31, 2013 and \$1.3 million as of December 31, 2012. Management believes that the proceeds obtained through a liquidation of collateral and the enforcement of guarantees would be sufficient to cover the potential amount of future payment required by the letters of credit. Management does not believe that the amount of the liability associated with guarantees under standby letters of credit outstanding at March 31, 2013 and December 31, 2012 is material.

#### **Note 15 – Derivative Financial Instruments**

As a part of managing interest rate risk, the Bank entered into interest rate swap agreements to modify the re-pricing characteristics of certain interest-bearing liabilities. The Corporation has designated these interest rate swap agreements as cash flow hedges under the guidance of ASC Subtopic 815-30, *Derivatives and Hedging – Cash Flow Hedges*. Cash flow hedges have the effective portion of changes in the fair value of the derivative, net of taxes, recorded in net accumulated other comprehensive income.

In July 2009, the Corporation entered into three interest rate swap contracts totaling \$20.0 million notional amount, hedging future cash flows associated with floating rate trust preferred debt. As of March 31, 2013 swap contracts totaling \$15.0 million notional amount remained, as the three-year \$5.0 million contract matured on June 15, 2012. The five-year \$10 million contract matures June 17, 2014 and the seven-year \$5 million contract matures June 17, 2016. The fair value of the interest rate swap contracts was (\$748) thousand at March 31, 2013 and (\$849) thousand at December 31, 2012 and was reported in Other Liabilities on the Consolidated Statement of Financial Condition. Cash in the amount of \$1.4 million was posted as collateral as of March 31, 2013.

For the three months ended March 31, 2013, the Corporation recorded an increase in the value of the derivatives of \$101 thousand and the related deferred tax benefit of \$41 thousand in net accumulated other comprehensive loss to reflect the effective portion of cash flow hedges. ASC Subtopic 815-30 requires this amount to be reclassified to earnings if the hedge becomes ineffective or is terminated. There was no hedge ineffectiveness recorded for the three months ending March 31, 2013. The Corporation does not expect any losses relating to these hedges to be reclassified into earnings within the next 12 months.

Interest rate swap agreements are entered into with counterparties that meet established credit standards and the Corporation believes that the credit risk inherent in these contracts is not significant as of March 31, 2013.

The table below discloses the impact of derivative financial instruments on the Corporation's Consolidated Financial Statements for the three-months ended March 31, 2013 and 2012.

| Derivative in Cash Flow Hedging Relationships | Amount of gain recognized in OCI on derivative (effective portion) | Amount of gain or (loss) reclassified from accumulated OCI into income (effective portion) <sup>(a)</sup> | Amount of gain or (loss) recognized in income on derivative (ineffective portion and amount excluded from effectiveness testing) <sup>(b)</sup> |
|---|--|---|---|
| (In thousands)                                |  |   |   |
| Interest rate contracts:                      |  |   |   |
| Three months ended:                           |  |   |   |
| March 31, 2013                                | \$ 60  | \$ 0  | \$ 0  |
| March 31, 2012                                | 27   | 0   | 0   |

Notes:

- (a) Reported as interest expense  
(b) Reported as other income

#### Note 16 – Variable Interest Entities (VIE)

As noted in Note 10, First United Corporation created the Trusts for the purposes of raising regulatory capital through the sale of mandatorily redeemable preferred capital securities to third party investors and common equity interests to First United Corporation. The Trusts are considered Variable Interest Entities (“VIEs”), but are not consolidated because First United Corporation is not the primary beneficiary of the Trusts. At March 31, 2013, the Corporation reported all of the \$41.7 million of TPS Debentures issued in connection with these offerings as long-term borrowings (along with the \$5.0 million of stand-alone junior subordinated debentures), and it reported its \$1.3 million equity interest in the Trusts as “Other Assets”.

In November 2009, the Bank became a 99.99% limited partner in Liberty Mews Limited Partnership (the “Partnership”), a Maryland limited partnership formed for the purpose of acquiring, developing and operating low-income housing units in Garrett County, Maryland. The Partnership was financed with a total of \$10.6 million of funding, including a \$6.1 million equity contribution from the Bank as the limited partner. The Partnership used the proceeds from these sources to purchase the land and construct a 36-unit low income housing rental complex at a total cost of \$10.6 million. The total assets of the Partnership were approximately \$9.9 million at March 31, 2013 and \$10.0 million at December 31, 2012.



As of December 31, 2011, the Bank had made contributions to the Partnership totaling \$6.1 million. The project was completed in June 2011, and the Bank is entitled to \$8.4 million in federal investment tax credits over a 10-year period as long as certain qualifying hurdles are maintained. The Bank will also receive the benefit of tax operating losses from the Partnership to the extent of its capital contribution. The investment in the Partnership assists the Bank in achieving its community reinvestment initiatives.

Because the Partnership is considered to be a VIE, management performed an analysis to determine whether its involvement with the Partnership would lead it to determine that it must consolidate the Partnership. In performing its analysis, management evaluated the risks creating the variability in the Partnership and identified which activities most significantly impact the VIE's economic performance. Finally, it examined each of the variable interest holders to determine which, if any, of the holders was the primary beneficiary based on their power to direct the most significant activities and their obligation to absorb potentially significant losses of the Partnership.

The Bank, as a limited partner, generally has no voting rights. The Bank is not in any way involved in the daily management of the Partnership and has no other rights that provide it with the power to direct the activities that most significantly impact the Partnership's economic performance, which are to develop and operate the housing project in such a manner that complies with specific tax credit guidelines. As a limited partner, there is no recourse to the Bank by the creditors of the Partnership. The tax credits that result from the Bank's investment in the Partnership are generally subject to recapture should the partnership fail to comply with the applicable government regulations. The Bank has not provided any financial or other support to the Partnership beyond its required capital contributions and does not anticipate providing such support in the future. Management currently believes that no material losses are probable as a result of the Bank's investment in the Partnership.

On the basis of management's analysis, the general partner is deemed to be the primary beneficiary of the Partnership. Because the Bank is not the primary beneficiary, the Partnership has not been included in the Corporation's consolidated financial statements.

At March 31, 2013 and December 31, 2012, the Corporation included its total investment in the Partnership in "Other Assets" in its Consolidated Statement of Financial Condition. As of March 31, 2013, the Corporation's commitment in the Partnership was fully funded. The following table presents details of the Bank's involvement with the Partnership at the dates indicated:

| (In thousands)                       | March 31,<br>2013 | December 31,<br>2012 |
|--------------------------------------|-------------------|----------------------|
| Investment in LIHTC Partnership      |                   |                      |
| Carrying amount on Balance Sheet of: |                   |                      |
| Investment (Other Assets)            | \$ 5,370          | \$ 5,498             |
| Maximum exposure to loss             | 5,370             | 5,498                |

#### **Note 17 – Assets and Liabilities Subject to Enforceable Master Netting Arrangements**

##### *Interest Rate Swap Agreements ("Swap Agreements")*

The Corporation has entered into interest rate swap agreements to modify the re-pricing characteristics of certain interest-bearing liabilities as a part of managing interest rate risk. The swap agreements have been designated as cash flow hedges, and accordingly, the fair value of the interest rate swap contracts is reported in Other Liabilities on the Consolidated Statement of Financial Condition. The swap agreements were entered into with a third party financial institution. The Corporation is party to master netting arrangements with its financial institution counterparty; however the Corporation does not offset assets and liabilities under these arrangements for financial statement presentation purposes. The master netting arrangements provide for a single net settlement of all swap agreements, as well as collateral, in the event of default on, or termination of, any one contract. Collateral, in the form of cash, is posted by the Corporation as the counterparty with net liability positions in accordance with contract thresholds. See Note 15 to the Consolidated Financial Statements for more information.

##### *Securities Sold Under Agreements to Repurchase ("Repurchase Agreements")*

The Bank enters into agreements under which it sells interests in U.S. Securities to certain customers subject to an obligation to repurchase, and on the part of the customers to resell, such interests. Under these arrangements, the Bank

may transfer legal control over the assets but still retain effective control through an agreement that both entitles and obligates the Bank to repurchase the assets. As a result, these repurchase agreements are accounted for as collateralized financing arrangements (i.e. secured borrowings) and not as a sale and subsequent repurchase of securities. The obligation to repurchase the securities is reflected as a liability in the consolidated statement of condition, while the securities underlying the repurchase agreements remain in the respective investment securities asset accounts. There is no offsetting or netting of the investment securities assets with the repurchase agreement liabilities. In addition, as the Bank does not enter into reverse repurchase agreements, there is no such offsetting to be done with the repurchase agreements. The right of setoff for a repurchase agreement resembles a secured borrowing, whereby the collateral would be used to settle the fair value of the repurchase agreement should the Bank be in default (i.e. fails to repurchase the U.S. Securities on the maturity date of the agreement). The investment security collateral is held by a third party financial institution in the counterparty's custodial account.

The following table presents the liabilities subject to an enforceable master netting arrangement or repurchase agreements as of March 31, 2013 and December 31, 2012.

| (In thousands)                | Gross Amounts of Recognized Liabilities | Gross Amounts Offset in the Statement of Condition | Net Amounts of Liabilities Presented in the Statement of Condition | Gross Amounts Not Offset in the Statement of Condition |                         |            |
|-------------------------------|---|--|--|--|-------------------------|------------|
|                               |   |  |  | Financial Instruments                                  | Cash Collateral Pledged | Net Amount |
| March 31, 2013                |   |  |  |  |                         |            |
| Interest Rate Swap Agreements | \$ 748                                  | \$ 0   | \$ 748   | \$ (748)   | \$ 0                    | \$ 0       |
| December 31, 2012             |   |  |  |  |                         |            |
| Interest Rate Swap Agreements | \$ 849                                  | \$ 0   | \$ 849   | \$ (849)   | \$ 0                    | \$ 0       |
| Repurchase Agreements         | \$ 39,257                               | \$ 0   | \$ 39,257  | \$ (39,257)  | \$ 0                    | \$ 0       |

#### Note 18 – Adoption of New Accounting Standards and Effects of New Accounting Pronouncements

In December 2011, the FASB issued Accounting Standards Update (“ASU”) No. 2011-11, “*Disclosures About Offsetting Assets and Liabilities*” The new disclosure requirements mandate that entities disclose both gross and net information about instruments and transactions eligible for offset in the statement of financial condition as well as instruments and transactions subject to an agreement similar to a master netting arrangement. ASU No. 2011-11 also requires disclosure of collateral received and posted in connection with master netting agreements or similar arrangements. In January 2013, the FASB issued ASU No. 2013-01, “*Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities.*” The provisions of ASU No. 2013-01 limit the scope of the new balance sheet offsetting disclosures to the following financial instruments, to the extent they are offset in the financial statements or subject to an enforceable master netting arrangement or similar agreement, irrespective of whether they are offset in the statement of financial condition: (a) derivative financial instruments; (b) repurchase agreements and reverse repurchase agreements; and (c) securities borrowing and securities lending transactions. The Corporation adopted the provisions of ASU No. 2011-11 and ASU No. 2013-01 effective January 1, 2013. As the provisions of ASU No. 2011-11 and ASU No. 2013-01 only impacted the disclosure requirements related to the offsetting of assets and liabilities and information about instruments and transactions eligible for offset in the statement of financial condition, the adoption had no impact on the Corporations’ consolidated statements of income and condition. See Note 17 to the Consolidated Financial Statements for the disclosures required by ASU No. 2011-11 and ASU No. 2013-01.

In February 2013, the FASB issued ASU No. 2013-02, "*Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income*," to improve the transparency of reporting these reclassifications. ASU No. 2013-02 does not amend any existing requirements for reporting net income or other comprehensive income in the financial statements. ASU No. 2013-02 requires an entity to disaggregate the total change of each component of other comprehensive income and separately present reclassification adjustments and current period other comprehensive income. The provisions of ASU No. 2013-02 also require that entities present in a single note or parenthetically on the face of the financial statements, the effect of significant amounts reclassified from each component of accumulated other comprehensive income based on its source and the income statement line item affected by the reclassification. If a component is not required to be reclassified to net income in its entirety, entities would instead cross-reference to the related note to the financial statements for additional information. The Corporation adopted the provisions of ASU No. 2013-02 effective January 1, 2013. As the Corporation provided these required disclosures in the notes to the Consolidated Financial Statements, the adoption of ASU No. 2013-02 had no impact on the Corporation's consolidated statements of income and condition. See Note 9 to the Consolidated Financial Statements for the disclosures required by ASU No. 2013-02.

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

### INTRODUCTION

The following discussion and analysis is intended as a review of material changes in and significant factors affecting the financial condition and results of operations of the First United Corporation and its consolidated subsidiaries for the periods indicated. This discussion and analysis should be read in conjunction with the unaudited consolidated financial statements and the notes thereto contained in Item 1 of Part I of this report. Unless the context clearly suggests otherwise, references in this report to “us”, “we”, “our”, and “the Corporation” are to First United Corporation and its consolidated subsidiaries.

### FORWARD-LOOKING STATEMENTS

This report may contain forward-looking statements within the meaning of The Private Securities Litigation Reform Act of 1995. Readers of this report should be aware of the speculative nature of “forward-looking statements.” Statements that are not historical in nature, including those that include the words “anticipate”, “estimate”, “should”, “expect”, “believe”, “intend”, and similar expressions, are based on current expectations, estimates and projections about, among other things, the industry and the markets in which we operate, and they are not guarantees of future performance. Whether actual results will conform to expectations and predictions is subject to known and unknown risks and uncertainties, including risks and uncertainties discussed in this report; general economic, market, or business conditions; changes in interest rates, deposit flow, the cost of funds, and demand for loan products and financial services; changes in our competitive position or competitive actions by other companies; changes in the quality or composition of our loan and investment portfolios; our ability to manage growth; changes in laws or regulations or policies of federal and state regulators and agencies; and other circumstances beyond our control. Consequently, all of the forward-looking statements made in this report are qualified by these cautionary statements, and there can be no assurance that the actual results anticipated will be realized, or if substantially realized, will have the expected consequences on our business or operations. These and other risks are discussed in detail in the periodic reports that First United Corporation files with the Securities and Exchange Commission (the “SEC”) (see Item 1A of Part II of this report for further information). Except as required by applicable laws, we do not intend to publish updates or revisions of any forward-looking statements we make to reflect new information, future events or otherwise.

### FIRST UNITED CORPORATION

First United Corporation is a Maryland corporation chartered in 1985 and a financial holding company registered under the federal Bank Holding Company Act of 1956, as amended. First United Corporation’s primary business is serving as the parent company of First United Bank & Trust, a Maryland trust company (the “Bank”), First United Statutory Trust I (“Trust I”) and First United Statutory Trust II (“Trust II”), both Connecticut statutory business trusts, and

First United Statutory Trust III, a Delaware statutory business trust (“Trust III” and together with Trust I and Trust II, the “Trusts”). The Trusts were formed for the purpose of selling trust preferred securities that qualified as Tier 1 capital. First United Corporation is also the parent company of First United Insurance Group, LLC, a Maryland limited liability company (the “Insurance Agency”) that, through the close of business on December 31, 2011, operated as a full service insurance agency. Effective on January 1, 2012, the Insurance Agency sold substantially all of its assets, net of cash, to a third-party and is no longer an active subsidiary. The Bank has three wholly-owned subsidiaries: OakFirst Loan Center, Inc., a West Virginia finance company; OakFirst Loan Center, LLC, a Maryland finance company (collectively, the “OakFirst Loan Centers”), and First OREO Trust, a Maryland statutory trust formed for the purposes of servicing and disposing of the real estate that the Bank acquires through foreclosure or by deed in lieu of foreclosure. Until March 27, 2013, the Bank also owned a majority interest in Cumberland Liquidation Trust, a Maryland statutory trust formed for the purposes of servicing and disposing of real estate that secured a loan made by another bank and in which the Bank held a participation interest, but this entity was dissolved on such date. The Bank also owns 99.9% of the limited partnership interests in Liberty Mews Limited Partnership, a Maryland limited partnership formed for the purpose of acquiring, developing and operating low-income housing units in Garrett County, Maryland.

At March 31, 2013, the Corporation had total assets of approximately \$1.3 billion, net loans of \$843.6 million, and deposits of approximately \$975.8 million. Shareholders’ equity at March 31, 2013 was approximately \$101.9 million.

The Corporation maintains an Internet site at [www.mybank4.com](http://www.mybank4.com) on which it makes available, free of charge, its Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, and all amendments to the foregoing as soon as reasonably practicable after these reports are electronically filed with, or furnished to, the SEC.

## ESTIMATES AND CRITICAL ACCOUNTING POLICIES

This discussion and analysis of our financial condition and results of operations is based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent liabilities. (See Note 1 of the Notes to Consolidated Financial Statements included in Item 8 of Part II of First United Corporation's Annual Report on Form 10-K for the year ended December 31, 2012.) On an on-going basis, management evaluates estimates, including those related to loan losses and intangible assets, other-than-temporary impairment ("OTTI") of investment securities, income taxes, fair value of investments and pension plan assumptions. Management bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. Management believes the following critical accounting policies affect our more significant judgments and estimates used in the preparation of the consolidated financial statements.

### *Allowance for Loan Losses*

One of our most important accounting policies is that related to the monitoring of the loan portfolio. A variety of estimates impact the carrying value of the loan portfolio, including the calculation of the allowance for loan losses (the "ALL"), the valuation of underlying collateral, the timing of loan charge-offs and the placement of loans on non-accrual status. The ALL is established and maintained at a level that management believes is adequate to cover losses resulting from the inability of borrowers to make required payment on loans. Estimates for loan losses are arrived at by analyzing risks associated with specific loans and the loan portfolio, current and historical trends in delinquencies and charge-offs, and changes in the size and composition of the loan portfolio. The analysis also requires consideration of the economic climate and direction, changes in lending rates, political conditions, legislation impacting the banking industry and economic conditions specific to Western Maryland and Northeastern West Virginia. Because the calculation of the ALL relies on management's estimates and judgments relating to inherently uncertain events, actual results may differ from management's estimates.

### *Goodwill and Other Intangible Assets*

Financial Accounting Standards Board Accounting Standards Codification ("ASC") Topic 350, *Intangibles - Goodwill and Other*, establishes standards for the amortization of acquired intangible assets and impairment assessment of goodwill. The \$11 million in recorded goodwill is primarily related to the acquisition of Huntington National Bank branches that occurred in 2003 and is not subject to periodic amortization.



Goodwill arising from business combinations represents the value attributable to unidentifiable intangible elements in the business acquired. Goodwill is not amortized but is tested for impairment annually or more frequently if events or changes in circumstances indicate that the asset might be impaired. Impairment testing requires that the fair value of each of the Corporation's reporting units be compared to the carrying amount of its net assets, including goodwill. If the estimated current fair value of the reporting unit exceeds its carrying value, no additional testing is required and an impairment loss is not recorded. Otherwise, additional testing is performed, and to the extent such additional testing results in a conclusion that the carrying value of goodwill exceeds its implied fair value, an impairment loss is recognized.

Our goodwill relates to value inherent in the banking business, and that value is dependent upon our ability to provide quality, cost effective services in a highly competitive local market. This ability relies upon continuing investments in processing systems, the development of value-added service features and the ease of use of our services. As such, goodwill value is ultimately supported by revenue that is driven by the volume of business transacted. A decline in earnings as a result of a lack of growth or the inability to deliver cost effective services over sustained periods can lead to impairment of goodwill, which could adversely impact earnings in future periods. ASC Topic 350 requires an annual evaluation of goodwill for impairment. The determination of whether or not these assets are impaired involves significant judgments and estimates.

### *Accounting for Income Taxes*

First United Corporation accounts for income taxes in accordance with ASC Topic 740, "Income Taxes". Under this guidance, deferred taxes are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates that will apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized as income or expense in the period that includes the enactment date.

Management regularly reviews the carrying amount of its net deferred tax assets to determine if the establishment of a valuation allowance is necessary. If based on the available evidence, it is more likely than not that all or a portion of the Company's net deferred tax assets will not be realized in future periods, a deferred tax valuation allowance would be established. Consideration is given to various positive and negative factors that could affect the realization of the deferred tax assets. In evaluating this available evidence, management considers, among other things, historical performance, expectations of future earnings, the ability to carry back losses to recoup taxes previously paid, length of statutory carry forward periods, experience with utilization of operating loss and tax credit carry forwards not expiring, tax planning strategies and timing of reversals of temporary differences. Significant judgment is required in assessing future earnings trends and the timing of reversals of temporary differences. The Corporation's evaluation is based on current tax laws as well as management's expectations of future performance.

Management expects that First United Corporation's adherence to the required accounting guidance may result in increased volatility in quarterly and annual effective income tax rates because of changes in judgment or measurement including changes in actual and forecasted income before taxes, tax laws and regulations, and tax planning strategies.

### *Other-Than-Temporary Impairment of Investment Securities*

Management systematically evaluates securities for impairment on a quarterly basis. Based upon application of accounting guidance for subsequent measurement in ASC Topic 320 (Section 320-10-35), management assesses whether (a) the Corporation has the intent to sell a security being evaluated and (b) it is more likely than not that the Corporation will be required to sell the security prior to its anticipated recovery. If neither applies, then declines in the fair values of securities below their cost that are considered other-than-temporary declines are split into two components. The first is the loss attributable to declining credit quality. Credit losses are recognized in earnings as realized losses in the period in which the impairment determination is made. The second component consists of all other losses, which are recognized in other comprehensive loss. In estimating OTTI losses, management considers (1) the length of time and the extent to which the fair value has been less than cost, (2) adverse conditions specifically related to the security, an industry, or a geographic area, (3) the historic and implied volatility of the fair value of the security, (4) changes in the rating of the security by a rating agency, (5) recoveries or additional declines in fair value subsequent to the balance sheet date, (6) failure of the issuer of the security to make scheduled interest or principal

payments, and (7) the payment structure of the debt security and the likelihood of the issuer being able to make payments that increase in the future. Management also monitors cash flow projections for securities that are considered beneficial interests under the guidance of ASC Subtopic 325-40, *Investments – Other – Beneficial Interests in Securitized Financial Assets*, (ASC Section 325-40-35). This process is described more fully in the Investment Securities section of the Consolidated Balance Sheet Review.

#### *Fair Value of Investments*

We have determined the fair value of our investment securities in accordance with the requirements of ASC Topic 820, *Fair Value Measurements and Disclosures*, which defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements required under other accounting pronouncements. The Corporation measures the fair market values of its investments based on the fair value hierarchy established in Topic 820. The determination of fair value of investments and other assets is discussed further in Note 8 to the consolidated financial statements presented elsewhere in this report.

#### *Pension Plan Assumptions*

Our pension plan costs are calculated using actuarial concepts, as discussed within the requirements of ASC Topic 715, *Compensation – Retirement Benefits*. Pension expense and the determination of our projected pension liability are based upon two critical assumptions: the discount rate and the expected return on plan assets. We evaluate each of these critical assumptions annually. Other assumptions impact the determination of pension expense and the projected liability including the primary employee demographics, such as retirement patterns, employee turnover, mortality rates, and estimated employer compensation increases. These factors, along with the critical assumptions, are carefully reviewed by management each year in consultation with our pension plan consultants and actuaries. Further information about our pension plan assumptions, the plan's funded status, and other plan information is included in Note 12 to the consolidated financial statements presented elsewhere in this report.

Other than as discussed above, management does not believe that any material changes in our critical accounting policies have occurred since December 31, 2012.

## SELECTED FINANCIAL DATA

The following table sets forth certain selected financial data for the three months ended March 31, 2013 and 2012 and is qualified in its entirety by the detailed information and unaudited financial statements, including the notes thereto, included elsewhere in this quarterly report.

|  | As of or For the three months<br>ended March 31, |   |          |    |
|--|--|---|----------|----|
|  | 2013   |   | 2012     |    |
| <b>Per Share Data</b>                                |  |   |          |    |
| Basic and diluted net income/(loss) per common share | \$ 0.24  |   | \$ (0.50 | )  |
| Book Value   | \$ 11.50   |   | \$ 10.32 |    |
| <b>Significant Ratios</b>                            |  |   |          |    |
| Return on Average Assets <sup>(a)</sup>              | 0.59   | % | (0.77    | )% |
| Return on Average Equity <sup>(a)</sup>              | 7.81   | % | (11.05   | )% |
| Average Equity to Average Assets                     | 7.57   | % | 7.01     | %  |

Note: <sup>(a)</sup> Annualized

## RESULTS OF OPERATIONS

### *Overview*

Consolidated net income available to common shareholders was \$1.5 million for the first three months of 2013, compared to a net loss attributable to common shareholders of \$3.1 million for the same period of 2012. Basic and diluted net income per common share for the first three months of 2013 was \$.24, compared to a net loss per common share of \$.50 for the same period of 2012. The change in earnings, from a net loss for the first three months of 2012 to net income for the first three months in 2013, was primarily due to a \$7.3 million decrease in the provision for loan losses during the first three months of 2013 when compared to the same time period of 2012. This decrease was offset by a decrease in net gains of \$.4 million due to reduced gains on sales of investment securities, and a decrease of \$.7 million in other income due to a reduction in bank-owned life insurance (“BOLI”) income driven by a one-time death

benefit of \$.7 million that occurred in March 2012. Total other operating expenses increased \$.5 million during the first three months of 2013 when compared to the same period of 2012. Other expenses related to other real estate owned (“OREO”) increased \$.6 million in the first quarter of 2013 when compared to the first quarter of 2012. The net interest margin for the first three months of 2013, on a fully tax equivalent (“FTE”) basis, decreased to 3.26% from 3.30% for the first three months of 2012. The net interest margin for the year ended December 31, 2012, on a FTE basis, was 3.30%.

The provision for loan losses decreased to \$.9 million for the three months ended March 31, 2013, compared to \$8.1 million for the same period of 2012. The lower provision expense in 2013 was primarily due to a loan charge-off of \$9.0 million on a shared national credit for an ethanol plant in western Pennsylvania during the first quarter of 2012 and charge-offs of \$1.1 million on a participation loan for a hotel located in Hazleton, Pennsylvania and \$.9 million on a motel located in Salisbury, Maryland during the first quarter of 2012. For the first quarter of 2013, we continued to see a leveling in the credit quality of our loan portfolio as we experienced fewer loan downgrades and delinquency levels have improved. Specific allocations have been made for impaired loans where management has determined that the collateral supporting the loans is not adequate to cover the loan balance, and the qualitative factors affecting the ALL have been adjusted based on the current economic environment and the characteristics of the loan portfolio.

Interest expense on our interest-bearing liabilities decreased \$.9 million during the three months ended March 31, 2013 when compared to the same period of 2012 due primarily to a decrease of \$77.4 million in average interest-bearing deposits and a \$24.2 million decrease in average long-term debt outstanding. The decline in average interest-bearing deposits and average long-term debt was due to the repayment of \$40.0 million in brokered certificates of deposit and the repayment of \$23.5 million in Federal Home Loan Bank (“FHLB”) advances at their stated maturities, respectively. During 2013, the Bank’s treasury team will continue to monitor rates on our deposits and increases special pricing only for full relationship customers. Our retail staff is focused on shifting our deposit mix away from higher cost certificates of deposit and towards lower cost money market and transaction accounts.

Other operating income decreased \$1.1 million during the first three months of 2013 when compared to the same period of 2012. This decrease was primarily attributable to a decline in BOLI income due to the one-time death benefit of \$.7 million received in March 2012. Net gains declined \$.4 million during the first quarter of 2013 when compared to the first quarter of 2012 due to a reduction in gains on sales of investment securities.

Operating expenses increased \$.5 million in the first three months of 2013 when compared to the same period of 2012. This increase was due to a \$.6 million reduction in gains on sales of OREO.

### *Net Interest Income*

Net interest income is the largest source of operating revenue and is the difference between the interest earned on interest-earning assets and the interest expense incurred on interest-bearing liabilities. For analytical and discussion purposes, net interest income is adjusted to a FTE basis to facilitate performance comparisons between taxable and tax-exempt assets. FTE income is determined by increasing tax-exempt income by an amount equal to the federal income taxes that would have been paid if this income were taxable at the statutorily applicable rate.

The following table sets forth the average balances, net interest income and expense, and average yields and rates of our interest-earning assets and interest-bearing liabilities for the three months ended March 31, 2013 and 2012:

| (in thousands)                | For the three months ended March 31, |          |              |                 |          |              |  |
|-------------------------------|--------------------------------------|----------|--------------|-----------------|----------|--------------|--|
|                               | 2013                                 |          |              | 2012            |          |              |  |
|                               | Average Balance                      | Interest | Average Rate | Average Balance | Interest | Average Rate |  |
| Interest-earning assets:      |                                      |          |              |                 |          |              |  |
| Loans                         | \$871,160                            | \$10,695 | 4.98 %       | \$934,940       | \$12,064 | 5.19 %       |  |
| Investment securities         | 243,990                              | 1,750    | 2.91         | 237,895         | 1,959    | 3.31         |  |
| Other interest earning assets | 75,429                               | 84       | 0.45         | 69,787          | 59       | 0.34         |  |

Edgar Filing: FIRST UNITED CORP/MD/ - Form 10-Q

|                                    |             |         |      |   |             |          |      |   |
|------------------------------------|-------------|---------|------|---|-------------|----------|------|---|
| Total earning assets               | \$1,190,579 | 12,529  | 4.27 | % | \$1,242,622 | 14,082   | 4.56 | % |
| Interest-bearing liabilities       |             |         |      |   |             |          |      |   |
| Interest-bearing deposits          | \$802,053   | 1,327   | 0.67 | % | \$879,448   | 1,893    | 0.87 | % |
| Short-term borrowings              | 38,520      | 14      | 0.15 |   | 35,297      | 46       | 0.52 |   |
| Long-term borrowings               | 182,725     | 1,614   | 3.58 |   | 206,923     | 1,946    | 3.78 |   |
| Total interest-bearing liabilities | \$1,023,298 | 2,955   | 1.17 | % | \$1,121,668 | 3,885    | 1.39 | % |
| Net interest income and spread     |             | \$9,574 | 3.10 | % |             | \$10,197 | 3.17 | % |
| Net interest margin                |             |         | 3.26 | % |             |          | 3.30 | % |

Note: Interest income and yields are presented on a fully taxable equivalent basis using a 35% tax rate.

Net interest income on a FTE basis decreased \$.6 million during the first three months of 2013 over the same period in 2012 due to a \$1.6 million (11.0%) decrease in interest income, which was partially offset by a \$.9 million (23.9%) decrease in interest expense. The decrease in interest income was primarily due to the \$63.8 million reduction in the average balance of loans when comparing the first quarter of 2013 to the same period of 2012. The slightly lower yield on both loans and investment securities, as funds were reinvested, also contributed to the decline in interest income when comparing the two periods. The decline in interest income was partially offset by a decline in interest expense due to the reduction in average balances in interest-bearing deposits and long-term borrowings. We saw a slight decline in the net interest margin in the first quarter of 2013 to 3.26% when compared to 3.30% at December 31, 2012 and March 31, 2012.

There was an overall \$52.0 million decrease in average interest-earning assets, driven by a \$63.8 million reduction in loans, offset by increases of \$6.1 million in investment securities and \$5.6 million in other interest earning assets, primarily cash.

Interest expense decreased during the first three months of 2013 when compared to the same period of 2012 due primarily to an overall reduction in average interest-bearing liabilities of \$98.4 million. This reduction was due to the repayments of \$40.0 in brokered deposits and \$23.5 million in long-term borrowings. The overall effect was a 22 basis point decrease in the average rate paid on our average interest-bearing liabilities, from 1.39% for the three months ended March 31, 2012 to 1.17% for the same period of 2013.

#### *Provision for Loan Losses*

The provision for loan losses was \$.9 million for the first three months of 2013, compared to \$8.1 million for the same period of 2012. The lower provision expense for the first three months was primarily due to the significantly lower net charge-offs in the first quarter of 2013 as well as overall lower loan balances. During 2013, we continue to see stabilization in our total rolling historical loss rates and the qualitative factors utilized in the determination of the ALL, as well as stabilization in the level of classified assets (discussed below in the section entitled "FINANCIAL CONDITION" under the heading "Allowance and Provision for Loan Losses"). Management strives to ensure that the ALL reflects a level commensurate with the risk inherent in our loan portfolio.

#### *Other Operating Income*

Other operating income, exclusive of gains, decreased \$.7 million during the first three months of 2013 when compared to the same period of 2012. The decrease was due to the reduction in BOLI income due to the one-time death benefit of \$.7 million received in March 2102.

Net gains of \$.3 million were reported through other income in the first three months of 2013, compared to net gains of \$.7 million during the same period of 2012. The reduction in net gains during the first quarter of 2013 when compared to the same period of 2012 was due to reduced gains on sales of investment securities.

The following table shows the major components of other operating income for the three months ended March 31, 2013 and 2012, exclusive of net gains:



Income as % of Total Other Operating Income  
 For the three months ended  
 March 31,

|                           | 2013 |   | 2012 |   |
|---------------------------|------|---|------|---|
| Service charges           | 26   | % | 21   | % |
| Trust department          | 36   | % | 28   | % |
| Debit card Income         | 14   | % | 12   | % |
| Bank owned life insurance | 8    | % | 24   | % |
| Brokerage income          | 5    | % | 5    | % |
| Other income              | 11   | % | 10   | % |
|                           | 100  | % | 100  | % |

*Other Operating Expenses*

Other operating expenses increased \$.5 million (5.4%) for the first three months of 2013 when compared to the first three months of 2012. This increase was due to a \$.6 million reduction in gains on sales of OREO.

The composition of other operating expenses for the three months ended March 31, 2013 and 2012 is illustrated in the following table.

|  | Expense as % of Total Other Operating Expenses |   |      |   |
|--|--|---|------|---|
|  | For the three months ended March 31,           |   |      |   |
|  | 2013   |   | 2012 |   |
| Salaries and employee benefits           | 50   | % | 53   | % |
| FDIC premiums                            | 5  | % | 5    | % |
| Occupancy, equipment and data processing | 22   | % | 23   | % |
| Other                                    | 23   | % | 19   | % |
|  | 100  | % | 100  | % |

#### *Applicable Income Taxes*

In reporting interim financial information, income tax provisions should be determined under the procedures set forth in ASC Topic 740, *Income Taxes* (Section 740-270-30). This guidance provides that at the end of each interim period, an entity should make its best estimate of the effective tax rate expected to be applicable for the full fiscal year. The rate so determined should be used in providing for income taxes on a current year-to-date basis. The effective tax rate should reflect anticipated investment tax credits, capital gains rates, and other available tax planning alternatives. In arriving at this effective tax rate, however, no effect should be included for the tax related to significant, unusual or extraordinary items that will be separately reported or reported net of their related tax effect in reports for the interim period or for the fiscal year.

The effective tax rate for the first three months of 2013 was 22.8%, compared to an effective tax rate of 1.5% for the first three months of 2012. Our effective income tax rates differed from the 35% federal statutory rate due to the effects of tax-exempt income on loans, securities and bank-owned life insurance, as well as the low income housing tax credits.

## **FINANCIAL CONDITION**

### *Balance Sheet Overview*

Total assets were \$1.3 billion at March 31, 2013, an increase of \$2.0 million since December 31, 2012. During this time period, cash and interest-bearing deposits in other banks increased \$1.8 million, the investment portfolio increased \$16.2 million, and gross loans decreased \$15.2 million. Total liabilities decreased by approximately \$1.0 million during the first three months of 2013, reflecting a decrease in total deposits of \$1.1 million offset by a slight increase in accrued interest payable and other liabilities. Shareholders' equity increased \$3.0 million from December 31, 2012 to March 31, 2013 as a result of the net income recognized during the first three months of 2013.

### *Loan Portfolio*

The following table presents the composition of our loan portfolio at the dates indicated:

| (In thousands)              | March 31, 2013 |      | December 31, 2012 |       |
|-----------------------------|----------------|------|-------------------|-------|
| Commercial real estate      | \$290,619      | 34 % | \$ 298,851        | 34 %  |
| Acquisition and development | 124,142        | 14   | 128,391           | 15    |
| Commercial and industrial   | 68,380         | 8    | 69,013            | 8     |
| Residential mortgage        | 348,979        | 41   | 346,919           | 40    |
| Consumer                    | 27,549         | 3    | 31,655            | 3     |
| Total Loans                 | \$859,669      | 100% | \$ 874,829        | 100 % |

Comparing March 31, 2013 to December 31, 2012, outstanding loans decreased by \$15.2 million (1.7%). Commercial Real Estate (“CRE”) loans decreased \$8.2 million as a result of the payoff of several large loans and ongoing scheduled principal payments. Acquisition and development (“A&D”) loans decreased \$4.3 million due to the movement of \$2.1 million from construction to permanent financing and \$2.2 million of payoffs. Commercial and industrial (“C&I”) loans decreased \$.6 million due to scheduled principal payments. Residential mortgages increased by \$2.1 million. The increase in the residential mortgage portfolio was attributable to the purchase of a pool of loans of approximately \$8.4 million in January 2013 offset by refinancings and regularly scheduled principal payments on existing loans. Management continues to use Fannie Mae for the majority of new, longer-term, fixed-rate residential loan originations. The consumer portfolio decreased \$4.1 million due primarily to repayment activity in the indirect auto portfolio slightly offsetting new production. At March 31, 2013 and December 31, 2012, approximately 60% of the commercial loan portfolio was collateralized by real estate.

### *Risk Elements of Loan Portfolio*

The following table presents the risk elements of our loan portfolio at the dates indicated. Management is not aware of any potential problem loans other than those listed in this table or discussed below.

| (In thousands)  | March 31,<br>2013 | % of<br>Applicable<br>Portfolio | December 31,<br>2012 | % of<br>Applicable<br>Portfolio |
|---|-------------------|---------------------------------|----------------------|---------------------------------|
| <b>Non-accrual loans:</b>                                     |                   |                                 |                      |                                 |
| Commercial real estate  | \$ 6,389          | 2.20                            | % \$ 6,194           | 2.07 %                          |
| Acquisition and development                                   | 12,533            | 10.10                           | % 10,778             | 8.39 %                          |
| Commercial and industrial                                     | 186               | 0.27                            | % 176                | 0.26 %                          |
| Residential mortgage  | 3,349             | 0.96                            | % 2,731              | 0.79 %                          |
| Consumer  | 115               | 0.42                            | % 36                 | 0.11 %                          |
| Total non-accrual loans                                       | \$ 22,572         | 2.63                            | % \$ 19,915          | 2.28 %                          |
| <b>Accruing Loans Past Due 90 days or more:</b>               |                   |                                 |                      |                                 |
| Commercial real estate  | \$ 64             |                                 | \$ 0                 |                                 |
| Acquisition and development                                   | 0                 |                                 | 200                  |                                 |
| Commercial and industrial                                     | 41                |                                 | 0                    |                                 |
| Residential mortgage  | 160               |                                 | 1,888                |                                 |
| Consumer  | 41                |                                 | 58                   |                                 |
| Total loans past due 90 days or more                          | \$ 306            |                                 | \$ 2,146             |                                 |
| Total non-accrual and accruing loans past due 90 days or more | \$ 22,878         |                                 | \$ 22,061            |                                 |
| <b>Restructured Loans (TDRs):</b>                             |                   |                                 |                      |                                 |
| Performing  | \$ 12,058         |                                 | \$ 12,134            |                                 |
| Non-accrual (included above)                                  | 5,535             |                                 | 5,540                |                                 |

|   |           |           |
|---|-----------|-----------|
| Total TDRs                                    | \$ 17,593 | \$ 17,674 |
| Other Real Estate Owned                       | \$ 16,188 | \$ 17,513 |
| Impaired loans without a valuation allowance  | \$ 37,578 | \$ 39,361 |
| Impaired loans with a valuation allowance     | 10,921    | 8,481     |
| Total impaired loans                          | \$ 48,499 | \$ 47,842 |
| Valuation allowance related to impaired loans | \$ 2,781  | \$ 1,632  |

*Other Real Estate Owned*

The following table presents the components of OREO as of March 31, 2013 and December 31, 2012:

|                             | March 31, 2013 | December 31, 2012 |
|-----------------------------|----------------|-------------------|
| Commercial real estate      | \$ 5,303       | \$ 5,559          |
| Acquisition and development | 9,357          | 9,831             |
| Residential mortgage        | 1,528          | 2,123             |
| Total OREO                  | \$ 16,188      | \$ 17,513         |

The following table presents the activity in the OREO valuation allowance for the three months ended March 31, 2013 and 2012:

|                          | 2013    | 2012    |
|--------------------------|---------|---------|
| Balance January 1        | \$2,766 | \$1,745 |
| Fair value write-down    | 20      | 0       |
| Sales of OREO            | (607 )  | (68 )   |
| Balance at end of period | \$2,179 | \$1,677 |

The following table presents the components of OREO expenses, net for the three months ended March 31, 2013 and 2012:

|                                   | For the three months ended<br>March 31, |           |
|-----------------------------------|---|-----------|
| (in thousands)                    | 2013                                    | 2012      |
| Gains on real estate, net         | \$ (7 )                                 | \$ (623 ) |
| Fair value write-down             | 20                                      | 0         |
| Expenses, net                     | 117                                     | 142       |
| Rental income                     | (112 )                                  | (69 )     |
| Total OREO expenses/(income), net | \$ 18                                   | \$ (550 ) |

Performing loans considered to be impaired (including performing troubled debt restructurings, or TDRs), as defined and identified by management, amounted to \$26.1 million at March 31, 2013 and \$28.2 million at December 31, 2012. Loans are identified as impaired when, based on current information and events, management determines that we will be unable to collect all amounts due according to contractual terms. These loans consist primarily of A&D loans and CRE loans. The fair values are generally determined based upon independent third party appraisals of the collateral or discounted cash flows based upon the expected proceeds. Specific allocations have been made where management

believes there is insufficient collateral to repay the loan balance if liquidated and there is no secondary source of repayment available.

The level of performing impaired loans (other than performing TDRs) decreased \$2.0 million during the three months ended March 31, 2013, due to the reclassification of a \$1.8 million A&D loan out of impaired status due to improved performance as well as \$.2 million of net principal repayments received in the year-to-date period. Management will continue to monitor all loans that have been removed from an impaired status and take appropriate steps to ensure that satisfactory performance is sustained.

The following table presents the details of impaired loans that are TDRs by class as of March 31, 2013 and December 31, 2012:

| (in thousands)                      | March 31, 2013            |                        | December 31, 2012         |                        |
|-------------------------------------|---------------------------|------------------------|---------------------------|------------------------|
|                                     | Number<br>of<br>Contracts | Recorded<br>Investment | Number<br>of<br>Contracts | Recorded<br>Investment |
| <b>Performing</b>                   |                           |                        |                           |                        |
| Commercial real estate              |                           |                        |                           |                        |
| Non owner-occupied                  | 2                         | \$ 268                 | 2                         | \$ 273                 |
| All other CRE                       | 5                         | 5,631                  | 5                         | 5,676                  |
| Acquisition and development         |                           |                        |                           |                        |
| 1-4 family residential construction | 1                         | 2,052                  | 1                         | 2,052                  |
| All other A&D                       | 6                         | 2,561                  | 4                         | 2,330                  |
| Commercial and industrial           | 2                         | 640                    | 2                         | 557                    |
| Residential mortgage                |                           |                        |                           |                        |
| Residential mortgage – term         | 4                         | 906                    | 4                         | 1,246                  |
| Residential mortgage – home equity  | 0                         | 0                      | 0                         | 0                      |
| Consumer                            | 0                         | 0                      | 0                         | 0                      |
| Total performing                    | 20                        | \$ 12,058              | 18                        | \$ 12,134              |
| <b>Non-accrual</b>                  |                           |                        |                           |                        |
| Commercial real estate              |                           |                        |                           |                        |
| Non owner-occupied                  | 1                         | \$ 448                 | 1                         | \$ 448                 |
| All other CRE                       | 0                         | 0                      | 0                         | 0                      |
| Acquisition and development         |                           |                        |                           |                        |
| 1-4 family residential construction | 0                         | 0                      | 0                         | 0                      |
| All other A&D                       | 6                         | 4,600                  | 6                         | 4,600                  |
| Commercial and industrial           | 0                         | 0                      | 0                         | 0                      |
| Residential mortgage                |                           |                        |                           |                        |
| Residential mortgage – term         | 2                         | 487                    | 2                         | 492                    |
| Residential mortgage – home equity  | 0                         | 0                      | 0                         | 0                      |
| Consumer                            | 0                         | 0                      | 0                         | 0                      |
| Total non-accrual                   | 9                         | 5,535                  | 9                         | 5,540                  |
| Total TDRs                          | 29                        | \$ 17,593              | 27                        | \$ 17,674              |

The level of TDRs decreased \$.1 million during the three months ended March 31, 2013. Three loans totaling \$.4 million were added to performing TDRs and two loans already in performing TDRs were re-modified. One loan totaling \$.5 million that had been modified prior to December 31, 2012 at a market rate is no longer reported as a performing TDR during 2013 because the borrower had made at least six consecutive payments and was current at the time of reclassification.



*Allowance and Provision for Loan Losses*

The ALL is maintained to absorb losses from the loan portfolio. The ALL is based on management's continuing evaluation of the quality of the loan portfolio, assessment of current economic conditions, diversification and size of the portfolio, adequacy of collateral, past and anticipated loss experience, and the amount of non-performing loans.

The ALL is also based on estimates, and actual losses will vary from current estimates. These estimates are reviewed quarterly, and as adjustments, either positive or negative, become necessary, a corresponding increase or decrease is made in the ALL. The methodology used to determine the adequacy of the ALL is consistent with prior years. An estimate for probable losses related to unfunded lending commitments, such as letters of credit and binding but unfunded loan commitments is also prepared. This estimate is computed in a manner similar to the methodology described above, adjusted for the probability of actually funding the commitment.

The following table presents a summary of the activity in the ALL for the three months ended March 31:

| (in thousands)  | 2013     | 2012     |
|---|----------|----------|
| Balance, January 1  | \$16,047 | \$19,480 |
| Charge-offs:  |          |          |
| Commercial real estate  | 0        | (1,161 ) |
| Acquisition and development   | (4 )     | (246 )   |
| Commercial and industrial   | (876 )   | (9,091 ) |
| Residential mortgage  | (155 )   | (283 )   |
| Consumer  | (143 )   | (173 )   |
| Total charge-offs   | (1,178 ) | (10,954) |
| Recoveries:   |          |          |
| Commercial real estate  | 100      | 0        |
| Acquisition and development   | 8        | 12       |
| Commercial and industrial   | 49       | 330      |
| Residential mortgage  | 31       | 99       |
| Consumer  | 103      | 122      |
| Total recoveries  | 291      | 563      |
| Net credit losses   | (887 )   | (10,391) |
| Provision for loan losses   | 865      | 8,124    |
| Balance at end of period  | \$16,025 | \$17,213 |
| Allowance for loan losses to loans outstanding (as %)                             | 1.86 %   | 1.88 %   |
| Net charge-offs to average loans outstanding during the period, annualized (as %) | 0.41 %   | 4.47 %   |

The ALL remained consistent at \$16.0 million at March 31, 2013 and December 31, 2012 compared to \$17.2 million at March 31, 2012. The provision for loan losses for the first three months of 2013 decreased to \$.9 million from \$8.1 million for the same period in 2012. Net charge-offs declined to \$.9 million for the three months ended March 31, 2013, compared to \$10.4 million for the three months ended March 31, 2012. Included in the net charge-offs for the three months ended March 31, 2013 was a \$.8 million charge-off for a C&I loan. The lower provision expense was due to the significantly lower level of net charge-offs as well as the lower level of loan balances. The ratio of the ALL to loans outstanding as of March 31, 2013 was 1.86%, which was slightly lower than the 1.88% for the same period last year.

The ratio of net charge-offs to average loans for the three months ended March 31, 2013 was an annualized .41%, compared to an annualized 4.47% for the same period in 2012 and 1.41% for the year ended December 31, 2012. Relative to December 31, 2012, all segments of loans showed improvement. The CRE portfolio had an annualized net recovery rate as of March 31, 2013 of .14% compared to an annualized net charge-off rate of .67% as of December 31, 2012. There were no net charge-offs for A&D loans as of March 31, 2013 compared to an annualized net charge-off rate of .29% as of December 31, 2012. The ratios for C&I loans were 4.82% and 12.10% for March 31, 2013 and December 31, 2012, respectively. The residential mortgage ratios were .14% and .33% for March 31, 2013 and December 31, 2012, respectively, and the consumer loan ratios were .54% and .69% for March 31, 2013 and December 31, 2012, respectively.

Accruing loans past due 30 days or more declined to 1.95% of the loan portfolio at March 31, 2013, compared to 2.39% at December 31, 2012. The decrease for the first three months of 2013 was primarily due to a decrease of \$2.8 million in past-due accruing residential mortgage – term loans and a \$2.2 million decrease in past-due accruing CRE loans. Other improvements in the levels of past-due loans were attributable to a combination of a slowly improving economy and vigorous collection efforts by the Bank.

Comparing the three-month periods ending March 31, 2013 and March 31, 2012, total non-accrual loan balances have declined. Non-accrual loans totaled \$22.6 million as of March 31, 2013, compared to \$19.9 million as of December 31, 2012 and \$28.6 million as of March 31, 2012. Non-accrual loans which have been subject to a partial charge-off totaled \$6.6 million as of March 31, 2013, compared to \$6.7 million as of December 31, 2012.

Management believes that the ALL at March 31, 2013 is adequate to provide for probable losses inherent in our loan portfolio. Amounts that will be recorded for the provision for loan losses in future periods will depend upon trends in the loan balances, including the composition of the loan portfolio, changes in loan quality and loss experience trends, potential recoveries on previously charged-off loans and changes in other qualitative factors. Management also applies interest rate risk, collateral value and debt service sensitivity analyses to the Commercial real estate loan portfolio and obtains new appraisals on specific loans under defined parameters to assist in the determination of the periodic provision for loan losses.

### *Investment Securities*

At March 31, 2013, the total amortized cost basis of the available-for-sale investment portfolio was \$260.1 million, compared to a fair value of \$239.4 million. Unrealized gains and losses on securities available-for-sale are reflected in accumulated other comprehensive loss, a component of shareholders' equity.

The following table presents the composition of our securities portfolio at amortized cost and fair values at the dates indicated:

| (Dollars in thousands)                          | March 31, 2013 |                 |                  | December 31, 2012 |                 |                  |  |
|---|----------------|-----------------|------------------|-------------------|-----------------|------------------|--|
|   | Amortized Cost | Fair Value (FV) | FV as % of Total | Amortized Cost    | Fair Value (FV) | FV as % of Total |  |
| <b>Securities Available-for-Sale:</b>           |                |                 |                  |                   |                 |                  |  |
| U.S. government agencies                        | \$47,425       | \$47,228        | 20 %             | \$40,334          | \$40,320        | 18 %             |  |
| Residential mortgage-backed agencies            | 81,432         | 81,418          | 34 %             | 43,596            | 44,108          | 20 %             |  |
| Commercial mortgage-backed agencies             | 14,934         | 15,026          | 6 %              | 37,330            | 37,618          | 17 %             |  |
| Collateralized mortgage obligations             | 23,054         | 23,279          | 9 %              | 31,836            | 31,731          | 14 %             |  |
| Obligations of state and political subdivisions | 56,308         | 58,691          | 25 %             | 55,212            | 58,054          | 26 %             |  |
| Collateralized debt obligations                 | 36,902         | 13,798          | 6 %              | 36,798            | 11,442          | 5 %              |  |
| Total available for sale                        | \$260,055      | \$239,440       | 100 %            | \$245,106         | \$223,273       | 100 %            |  |
| <b>Securities Held to Maturity:</b>             |                |                 |                  |                   |                 |                  |  |
| Obligations of state and political subdivisions | \$4,040        | \$4,318         | 100 %            | \$4,040           | \$4,347         | 100 %            |  |

Total investment securities available-for-sale increased \$16.2 million since December 31, 2012. At March 31, 2013, the securities classified as available-for-sale included a net unrealized loss of \$20.6 million, which represents the difference between the fair value and amortized cost of securities in the portfolio.

As discussed in Note 8 to the consolidated financial statements presented elsewhere in this report, the Corporation measures fair market values based on the fair value hierarchy established in ASC Topic 820, *Fair Value Measurements and Disclosures*. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). Level 3 prices or valuation techniques require inputs that are both significant to the valuation assumptions and are not readily observable in the market (i.e. supported with little or no market activity). These Level 3 instruments are valued based on both observable and unobservable inputs derived from the best available data, some of which is internally developed, and considers risk premiums that a market participant would require.

Approximately \$225.6 million of the available-for-sale portfolio was valued using Level 2 pricing, and had net unrealized gains of \$2.5 million at March 31, 2013. The remaining \$13.8 million of the securities available-for-sale represents the entire CDO portfolio, which was valued using significant unobservable inputs (Level 3 assets). The \$23.1 million in unrealized losses associated with this portfolio relates to 17 of the 18 pooled trust preferred securities that comprise the CDO portfolio. Unrealized losses of \$15.2 million represent non-credit related OTTI charges on 13 of the securities, while \$7.9 million of unrealized losses relates to five securities which have had no credit related OTTI. The unrealized losses on these securities were primarily attributable to continued depression in the marketability and liquidity associated with CDOs.

The following table provides a summary of the trust preferred securities in the CDO portfolio and the credit status of these securities as of March 31, 2013.

### Level 3 Investment Securities Available for Sale

(Dollars in Thousands)

| Investment Description         |       | First United Level 3 Investments |                   |                        |                      | Security Credit Status |   |                       |                    |  |  |
|--------------------------------|-------|----------------------------------|-------------------|------------------------|----------------------|------------------------|---|-----------------------|--------------------|--|--|
| Deal                           | Class | Amortized Cost                   | Fair Market Value | Unrealized Gain/(Loss) | Lowest Credit Rating | Original Collateral    | Deferrals/ Defaults as % of Original Collateral | Performing Collateral | Collateral Support | Collateral Support as % of Performing Collateral | Number of Performing Issuers/Total Issuers |
| Preferred Term Security I      | Mezz  | 649                              | 556               | (93 )                  | C                    | 303,112                | 19.46%  | 77,500                | (10,772 )          | -13.90%  | 9/13                                       |
| Preferred Term Security XI*    | B-1   | 1,340                            | 433               | (907 )                 | C                    | 635,775                | 28.67%  | 391,105               | (115,393 )         | -29.50%  | 42/62                                      |
| Preferred Term Security XVI*   | C     | 255                              | 290               | 35                     | C                    | 606,040                | 41.86%  | 318,000               | (165,189 )         | -51.95%  | 34/56                                      |
| Preferred Term Security XVIII  | C     | 3,036                            | 826               | (2,210 )               | C                    | 676,565                | 28.69%  | 464,843               | (96,251 )          | -20.71%  | 49/75                                      |
| Preferred Term Security XVIII* | C     | 2,124                            | 551               | (1,573 )               | C                    | 676,565                | 28.69%  | 464,843               | (96,251 )          | -20.71%  | 49/75                                      |
| Preferred Term Security XIX*   | C     | 3,048                            | 763               | (2,285 )               | C                    | 700,535                | 20.01%  | 484,731               | (106,708 )         | -22.01%  | 46/66                                      |
| Preferred Term Security XIX*   | C     | 1,319                            | 327               | (992 )                 | C                    | 700,535                | 20.01%  | 484,731               | (106,708 )         | -22.01%  | 46/66                                      |
| Preferred Term Security        | C     | 1,321                            | 327               | (994 )                 | C                    | 700,535                | 20.01%  | 484,731               | (106,708 )         | -22.01%  | 46/66                                      |

Edgar Filing: FIRST UNITED CORP/MD/ - Form 10-Q

|  |     |        |        |          |      |           |         |         |           |          |        |
|--|-----|--------|--------|----------|------|-----------|---------|---------|-----------|----------|--------|
| XIX*<br>Preferred<br>Term<br>Security                | C   | 2,214  | 545    | (1,669 ) | C    | 700,535   | 20.01 % | 484,731 | (106,708) | -22.01 % | 46/66  |
| XIX*<br>Preferred<br>Term<br>Security                | C-1 | 3,977  | 1,509  | (2,468 ) | C    | 1,386,600 | 25.10 % | 933,600 | (134,943) | -14.45 % | 61/91  |
| XXII*<br>Preferred<br>Term<br>Security               | C-1 | 1,591  | 603    | (988 )   | C    | 1,386,600 | 25.10 % | 933,600 | (134,943) | -14.45 % | 61/91  |
| XXII*<br>Preferred<br>Term<br>Security               | C-1 | 2,089  | 704    | (1,385 ) | C    | 1,467,000 | 21.88 % | 908,637 | (90,875 ) | -10.00 % | 87/112 |
| XXIII*<br>Preferred<br>Term<br>Security              | D-1 | 2,250  | 780    | (1,470 ) | C    | 1,467,000 | 21.88 % | 908,637 | (203,965) | -22.45 % | 87/112 |
| XXIII*<br>Preferred<br>Term<br>Security              | D-1 | 750    | 260    | (490 )   | C    | 1,467,000 | 21.88 % | 908,637 | (203,965) | -22.45 % | 87/112 |
| XXIII*<br>Preferred<br>Term<br>Security              | C-1 | 939    | 255    | (684 )   | C    | 1,050,600 | 32.12 % | 660,324 | (196,924) | -29.82 % | 57/86  |
| XXIV*<br>Preferred<br>Term<br>Security               | B-2 | 2,000  | 1,261  | (739 )   | CCC- | 351,000   | 9.26 %  | 156,000 | 10,235    | 6.56 %   | 14/16  |
| I-P-I<br>Preferred<br>Term<br>Security               | B-1 | 3,000  | 1,428  | (1,572 ) | CCC- | 325,000   | 7.08 %  | 209,150 | 22,785    | 10.89 %  | 23/25  |
| I-P-IV<br>Preferred<br>Term<br>Security              | B-1 | 5,000  | 2,380  | (2,620 ) | CCC- | 325,000   | 7.08 %  | 209,150 | 22,785    | 10.89 %  | 23/25  |
| I-P-IV   |     |        |        |          |      |           |         |         |           |          |        |
| Total Level 3<br>Securities<br>Availab e for<br>Sale |     | 36,902 | 13,798 | (23,104) |      |           |         |         |           |          |        |

\* Security has been deemed other-than-temporarily impaired and loss has been recognized in accordance with ASC Section 320-10-35.

The terms of the debentures underlying trust preferred securities allow the issuer of the debentures to defer interest payments for up to 20 quarters, and, in such case, the terms of the related trust preferred securities allow their issuers to defer dividend payments for up to 20 quarters. Some of the issuers of the trust preferred securities in our investment portfolio have defaulted and/or deferred payments ranging from 7.08% to 41.86% of the total collateral balances underlying the securities. The securities were designed to include structural features that provide investors with credit enhancement or support to provide default protection by subordinated tranches. These features include over-collateralization of the notes or subordination, excess interest or spread which will redirect funds in situations where collateral is insufficient, and a specified order of principal payments. There are securities in our portfolio that are under-collateralized, which does represent additional stress on our tranche. However, in these cases, the terms of the securities require excess interest to be redirected from subordinate tranches as credit support, which provides additional support to our investment.

Management systematically evaluates securities for impairment on a quarterly basis. Based upon application of ASC Topic 320 (Section 320-10-35), management must assess whether (a) the Corporation has the intent to sell the security and (b) it is more likely than not that the Corporation will be required to sell the security prior to its anticipated recovery. If neither applies, then declines in the fair value of securities below their cost that are considered other-than-temporary declines are split into two components. The first is the loss attributable to declining credit quality. Credit losses are recognized in earnings as realized losses in the period in which the impairment determination is made. The second component consists of all other losses. The other losses are recognized in other comprehensive income. In estimating OTTI charges, management considers (1) the length of time and the extent to which the fair value has been less than cost, (2) adverse conditions specifically related to the security, an industry, or a geographic area, (3) the historic and implied volatility of the security, (4) changes in the rating of a security by a rating agency, (5) recoveries or additional declines in fair value subsequent to the balance sheet date, (6) failure of the issuer of the security to make scheduled interest payments, and (7) the payment structure of the debt security and the likelihood of the issuer being able to make payments that increase in the future. Due to the duration and the significant market value decline in the pooled trust preferred securities held in our portfolio, we performed more extensive testing on these securities for purposes of evaluating whether or not an OTTI has occurred.

The market for these securities as of March 31, 2013 is not active and markets for similar securities are also not active. The inactivity was evidenced first by a significant widening of the bid-ask spread in the brokered markets in which these securities trade and then by a significant decrease in the volume of trades relative to historical levels. The new issue market is also inactive, as no new CDOs have been issued since 2007. There are currently very few market participants who are willing to effect transactions in these securities. The market values for these securities, or any securities other than those issued or guaranteed by the U.S. Department of the Treasury (the "Treasury"), are very depressed relative to historical levels. Therefore, in the current market, a low market price for a particular bond may only provide evidence of stress in the credit markets in general rather than being an indicator of credit problems with a particular issue. Given the conditions in the current debt markets and the absence of observable transactions in the secondary and new issue markets, management has determined that (a) the few observable transactions and market quotations that are available are not reliable for the purpose of obtaining fair value at March 31, 2013, (b) an income valuation approach technique (i.e. present value) that maximizes the use of relevant observable inputs and minimizes the use of observable inputs will be equally or more representative of fair value than a market approach, and (c) the CDO segment is appropriately classified within Level 3 of the valuation hierarchy because management determined that significant adjustments were required to determine fair value at the measurement date.





Management utilizes an independent third party to prepare both the evaluations of OTTI and the fair value determinations for the CDO portfolio. Management does not believe that there were any material differences in the impairment evaluations and pricing between December 31, 2012 and March 31, 2013.

The approach of the third party to determine fair value involved several steps, including detailed credit and structural evaluation of each piece of collateral in each bond, default, recovery and prepayment/amortization probabilities for each piece of collateral in the bond, and discounted cash flow modeling. The discount rate methodology used by the third party combines a baseline current market yield for comparable corporate and structured credit products with adjustments based on evaluations of the differences found in structure and risks associated with actual and projected credit performance of each CDO being valued. Currently, the only active and liquid trading market that exists is for stand-alone trust preferred securities. Therefore, adjustments to the baseline discount rate are also made to reflect the additional leverage found in structured instruments.

Based upon a review of credit quality and the cash flow tests performed by the independent third party, management determined that no securities had credit-related OTTI during the first three months of 2013.

The risk-based capital ratios require that banks set aside additional capital for securities that are rated below investment grade. Securities rated one level below investment grade require a 200% risk weighting. Additional methods are applicable to securities rated more than one level below investment grade. Management believes that, as of March 31, 2013, we maintain sufficient capital and liquidity to cover the additional capital requirements of these securities and future operating expenses. Additionally, we do not anticipate any material commitments or expected outlays of capital in the near term.

### *Deposits*

The following table presents the composition of our deposits as of the dates indicated:

| (In thousands)                       | March 31, 2013 |      | December 31, 2012 |      |
|--------------------------------------|----------------|------|-------------------|------|
| Non-interest bearing demand deposits | \$184,288      | 19 % | \$161,500         | 17 % |
| Interest-bearing deposits:           |                |      |                   |      |
| Demand                               | 122,214        | 12   | 119,306           | 12   |
| Money Market:                        |                |      |                   |      |
| Retail                               | 191,505        | 20   | 202,678           | 21   |
| Savings deposits                     | 113,578        | 12   | 109,740           | 11   |
| Time deposits less than \$100,000:   |                |      |                   |      |

Edgar Filing: FIRST UNITED CORP/MD/ - Form 10-Q

|                                  |           |      |           |      |
|----------------------------------|-----------|------|-----------|------|
| Retail                           | 185,196   | 19   | 187,289   | 19   |
| Brokered/CDARS                   | 1,035     | 0    | 1,052     | 0    |
| Time deposits \$100,000 or more: |           |      |           |      |
| Retail                           | 166,284   | 17   | 164,085   | 17   |
| Brokered/CDARS                   | 11,700    | 1    | 31,234    | 3    |
| Total Deposits                   | \$975,800 | 100% | \$976,884 | 100% |

Total deposits decreased \$1.1 million during the first three months of 2013 when compared to deposits at December 31, 2012. Non-interest bearing deposits increased \$22.8 million. Traditional savings accounts increased \$3.8 million due to continued growth in our Prime Saver product. Total demand deposits increased \$2.9 million and total money market accounts decreased \$11.2 million. Time deposits less than \$100,000 declined \$2.1 million and time deposits greater than \$100,000 decreased \$17.3 million due to the repayment of a \$20.0 million brokered certificate of deposit at its maturity in January 2013. Our internal treasury team continues to promote the strategy of increasing our net interest margin by changing the mix of our deposit base and focusing on customers with full banking relationships.

*Borrowed Funds*

The following table presents the composition of our borrowings at the dates indicated:

| (In thousands)                                 | March 31,<br>2013 | December 31,<br>2012 |
|--|-------------------|----------------------|
| Securities sold under agreements to repurchase | \$ 38,633         | \$ 39,257            |
| Total short-term borrowings                    | \$ 38,633         | \$ 39,257            |
| <br>   |                   |                      |
| FHLB advances                                  | \$ 135,990        | \$ 136,005           |
| Junior subordinated debt                       | 46,730            | 46,730               |
| Total long-term borrowings                     | \$ 182,720        | \$ 182,735           |

Total short-term borrowings decreased by approximately \$.6 million during the first three months of 2013 due to decreases in treasury management customer deposits. Long-term borrowings decreased by \$15.0 thousand during the first three months of 2013 due to the scheduled monthly amortization of long-term advances.

*Liquidity Management*

Liquidity is a financial institution's capability to meet customer demands for deposit withdrawals while funding all credit-worthy loans. The factors that determine the institution's liquidity are:

- Reliability and stability of core deposits;
- Cash flow structure and pledging status of investments; and
- Potential for unexpected loan demand.

We actively manage our liquidity position through weekly meetings of a sub-committee of executive management, known as the Treasury Sub-Committee, which looks forward 12 months at 30-day intervals. The measurement is based upon the projection of funds sold or purchased position, along with ratios and trends developed to measure dependence on purchased funds and core growth. Monthly reviews by management and quarterly reviews by the Asset and Liability Committee under prescribed policies and procedures are designed to ensure that we will maintain adequate levels of available funds.

It is our policy to manage our affairs so that liquidity needs are fully satisfied through normal Bank operations. That is, the Bank will manage its liquidity to minimize the need to make unplanned sales of assets or to borrow funds under emergency conditions. The Bank will use funding sources where the interest cost is relatively insensitive to market changes in the short run (periods of one year or less) to satisfy operating cash needs. The remaining normal funding will come from interest-sensitive liabilities, either deposits or borrowed funds. When the marginal cost of needed wholesale funding is lower than the cost of raising this funding in the retail markets, the Corporation may supplement retail funding with external funding sources such as:

1. Unsecured Fed Funds lines of credit with upstream correspondent banks (M&T Bank, Atlantic Central Banker's Bank, Community Banker's Bank).  
Secured advances with the FHLB of Atlanta, which are collateralized by eligible one to four family residential
2. mortgage loans, home equity lines of credit, commercial real estate loans, and various securities. Cash may also be pledged as collateral.
3. Secured line of credit with the Fed Discount Window for use in borrowing funds up to 90 days, using municipal securities as collateral.
4. Brokered deposits, including CDs and money market funds, provide a method to generate deposits quickly. These deposits are strictly rate driven but often provide the most cost effective means of funding growth.
5. One Way Buy CDARS funding – a form of brokered deposits that has become a viable supplement to brokered deposits obtained directly.

Management believes that we have adequate liquidity available to respond to current and anticipated liquidity demands and is not aware of any trends or demands, commitments, events or uncertainties that are likely to materially affect our ability to maintain liquidity at satisfactory levels.

### *Market Risk and Interest Sensitivity*

Our primary market risk is interest rate fluctuation. Interest rate risk results primarily from the traditional banking activities that we engage in, such as gathering deposits and extending loans. Many factors, including economic and financial conditions, movements in interest rates and consumer preferences affect the difference between the interest earned on our assets and the interest paid on our liabilities. Interest rate sensitivity refers to the degree that earnings will be impacted by changes in the prevailing level of interest rates. Interest rate risk arises from mismatches in the repricing or maturity characteristics between interest-bearing assets and liabilities. Management seeks to minimize fluctuating net interest margins, and to enhance consistent growth of net interest income through periods of changing interest rates. Management uses interest sensitivity gap analysis and simulation models to measure and manage these risks. The interest rate sensitivity gap analysis assigns each interest-earning asset and interest-bearing liability to a time frame reflecting its next repricing or maturity date. The differences between total interest-sensitive assets and liabilities at each time interval represent the interest sensitivity gap for that interval. A positive gap generally indicates that rising interest rates during a given interval will increase net interest income, as more assets than liabilities will reprice. A negative gap position would benefit us during a period of declining interest rates.

At March 31, 2013, we were asset sensitive.

Our interest rate risk management goals are:

- Ensure that the Board of Directors and senior management will provide effective oversight and ensure that risks are adequately identified, measured, monitored and controlled;
- Enable dynamic measurement and management of interest rate risk;
- Select strategies that optimize our ability to meet our long-range financial goals while maintaining interest rate risk within policy limits established by the Board of Directors;
- Use both income and market value oriented techniques to select strategies that optimize the relationship between risk and return; and
- Establish interest rate risk exposure limits for fluctuation in net interest income (“NII”), net income and economic value of equity.

In order to manage interest sensitivity risk, management formulates guidelines regarding asset generation and pricing, funding sources and pricing, and off-balance sheet commitments. These guidelines are based on management’s outlook regarding future interest rate movements, the state of the regional and national economy, and other financial and

business risk factors. Management uses computer simulations to measure the effect on net interest income of various interest rate scenarios. Key assumptions used in the computer simulations include cash flows and maturities of interest rate sensitive assets and liabilities, changes in asset volumes and pricing, and management's capital plans. This modeling reflects interest rate changes and the related impact on net interest income over specified periods.

We evaluate the effect of a change in interest rates of +/-100 basis points to +/-400 basis points on both NII and Net Portfolio Value ("NPV") / Economic Value of Equity ("EVE"). We concentrate on NII rather than net income as long as NII remains the significant contributor to net income.

NII modeling allows management to view how changes in interest rates will affect the spread between the yield paid on assets and the cost of deposits and borrowed funds. Unlike traditional Gap modeling, NII modeling takes into account the different degree to which installments in the same repricing period will adjust to a change in interest rates. It also allows the use of different assumptions in a falling versus a rising rate environment. The period considered by the NII modeling is the next eight quarters.

NPV / EVE modeling focuses on the change in the market value of equity. NPV / EVE is defined as the market value of assets less the market value of liabilities plus/minus the market value of any off-balance sheet positions. By effectively looking at the present value of all future cash flows on or off the balance sheet, NPV / EVE modeling takes a longer-term view of interest rate risk. This complements the shorter-term view of the NII modeling.

Measures of NII at risk produced by simulation analysis are indicators of an institution's short-term performance in alternative rate environments. These measures are typically based upon a relatively brief period, usually one year. They do not necessarily indicate the long-term prospects or economic value of the institution.

### *Capital Resources*

The Bank and First United Corporation are subject to risk-based capital regulations, which were adopted and are monitored by federal banking regulators. These guidelines are used to evaluate capital adequacy and are based on an institution's asset risk profile and off-balance sheet exposures, such as unused loan commitments and stand-by letters of credit. The regulatory guidelines require that a portion of total capital be Tier 1 capital, consisting of common shareholders' equity, qualifying portion of trust issued preferred securities, and perpetual preferred stock, less goodwill and certain other deductions. The remaining capital, or Tier 2 capital, consists of elements such as subordinated debt, mandatory convertible debt, remaining portion of trust issued preferred securities, and grandfathered senior debt, plus the ALL, subject to certain limitations.

Under the risk-based capital regulations, banking organizations are required to maintain a minimum total risk-based capital ratio (total qualifying capital divided by risk-weighted assets) of 8% (10% for well capitalized banks), including a Tier 1 ratio of at least 4% (6% for well capitalized banks). The risk-based capital rules have been further supplemented by a leverage ratio, defined as Tier I capital divided by average assets, after certain adjustments. The minimum leverage ratio is 4% (5% for well capitalized banks) for banking organizations that do not anticipate significant growth and have well-diversified risk (including no undue interest rate risk exposure), excellent asset quality, high liquidity and good earnings, and between 4% and 5% for other institutions depending on their particular condition and growth plans. Regulators may require higher capital ratios when warranted by the particular circumstances or risk profile of a given banking organization. In the current regulatory environment, banking organizations must stay well capitalized in order to receive favorable regulatory treatment on acquisition and other expansion activities and favorable risk-based deposit insurance assessments. Our capital policy establishes guidelines meeting these regulatory requirements and takes into consideration current or anticipated risks as well as potential future growth opportunities.

The following table presents our capital ratios:

|   | March 31,<br>2013 |   | December 31,<br>2012 |   | Required for<br>Capital<br>Adequacy<br>Purposes |   | Required To<br>Be Well<br>Capitalized |   |
|---|-------------------|---|----------------------|---|---|---|---------------------------------------|---|
| Total Capital (to risk-weighted assets) |                   |   |                      |   |   |   |                                       |   |
| Consolidated                            | 14.68             | % | 14.13                | % | 8.00  | % | 10.00                                 | % |
| First United Bank & Trust               | 15.19             | % | 14.63                | % | 8.00  | % | 10.00                                 | % |



Edgar Filing: FIRST UNITED CORP/MD/ - Form 10-Q

|  |       |   |       |   |      |   |      |   |
|--|-------|---|-------|---|------|---|------|---|
| Tier 1 Capital (to risk-weighted assets) |       |   |       |   |      |   |      |   |
| Consolidated                             | 13.12 | % | 12.54 | % | 4.00 | % | 6.00 | % |
| First United Bank & Trust                | 13.91 | % | 13.35 | % | 4.00 | % | 6.00 | % |
| Tier 1 Capital (to average assets)       |       |   |       |   |      |   |      |   |
| Consolidated                             | 11.02 | % | 10.32 | % | 4.00 | % | 5.00 | % |
| First United Bank & Trust                | 11.67 | % | 10.98 | % | 4.00 | % | 5.00 | % |

As of March 31, 2013, the most recent notification from the regulators categorized First United Corporation and the Bank as “well capitalized” under the regulatory framework for prompt corrective action. All capital ratios increased at March 31, 2013 when compared to December 31, 2012.

Basel is a committee of central banks and bank regulators from major industrialized countries that develops broad policy guidelines for use by each country’s regulators with the purpose of ensuring that financial institutions have adequate capital given the risk levels of assets and off-balance sheet financial instruments.

In December 2010, Basel released Basel III, a framework for strengthening international capital and liquidity regulations. Basel III includes defined minimum capital ratios, which was scheduled to be implemented on January 1, 2013. An additional “capital conservation buffer” will be phased-in beginning January 1, 2016 and, when fully phased-in three years later, the minimum ratios will be 2.5% higher. Fully phased-in capital standards under Basel III will require banks to maintain more capital than the minimum levels required under current regulatory capital standards. As Basel III is only a framework, the specific changes in capital requirements are to be determined by each country’s banking regulators.

In June 2012, U.S. Federal banking regulators issued two notices of proposed rulemaking (“NPRs”) that would implement in the United States the Basel III regulatory capital reforms and changes required by the Dodd-Frank Act. A third issued NPR related to banks that are internationally active or that are subject to market risk rules is not applicable to the Corporation.

The first NPR, “Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, and Transition Provisions”, would apply to all depository institutions, bank holding companies with total consolidated assets of \$500 million or more, and savings and loan holding companies (collectively, “banking organizations”). Consistent with the international Basel framework, this NPR would:

- Increase the quantity and quality of capital required by proposing a new minimum Common Equity Tier 1 capital ratio of 4.50% of risk-weighted assets and raising the minimum Tier 1 capital ratio from 4.00% to 6.00% of risk-weighted assets;

- Retain the current minimum Total capital ratio of 8.00% of risk-weighted assets and the minimum Tier 1 leverage capital ratio at 4.00% of average assets;

- Introduce a “capital conservation buffer” of 2.50% above the minimum risk-based capital requirements, which must be maintained to avoid restrictions on capital distributions and certain discretionary bonus payments; and

- Revise the definition of capital to improve the ability of regulatory capital instruments to absorb losses.

The proposed new minimum regulatory capital requirements would be phased in from January 1, 2013 through January 1, 2016. The proposed capital conservation buffer would be phased in from January 1, 2016 through January 1, 2019.

The second NPR, “Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirement,” also would apply to all banking organizations. This NPR would revise and harmonize the

rules for calculating risk-weighted assets to enhance risk sensitivity and address weaknesses that have been identified over the past several years. Banks and regulators use risk weighting to assign different levels of risk to different classes of assets and off balance sheet exposures - riskier items require higher capital cushions and less risky items require smaller capital cushions.

On November 9, 2012, following a public comment period, the U.S. federal banking agencies issued a joint press release announcing that the January 1, 2013 effective date was being delayed so the agencies could consider operational and transitional issues identified in the large volume of public comments received. It is anticipated that the U.S. federal banking agencies will formalize the implementation of the Basel III framework applicable to domestic banks in the United States during 2013.

We are in the process of modeling our capital ratios under various scenarios in light of these NPRs and intend to take appropriate steps to ensure that we will meet the fully-phased in minimum capital requirements, including capital conservation buffers, if and when the NPRs become final.

The total risk based capital ratios of First United Corporation include \$40.8 million of junior subordinated debentures ("TPS Debentures") which qualified as Tier 1 capital at March 31, 2013, under guidance issued by the Board of Governors of the Federal Reserve System. First United Corporation will monitor the finalization of the Basel III Capital Rules, including whether its TPS Debentures will continue to qualify for Tier 1 capital under the final rules.

In January 2009, pursuant to the Treasury's Troubled Asset Relieve Program Capital Purchase Program, First United Corporation sold 30,000 shares of its Series A Preferred Stock and a Warrant to purchase 326,323 shares of its common stock, having an exercise price of \$13.79 per share, to the Treasury for an aggregate purchase price of \$30 million. The proceeds from this transaction count as Tier 1 capital and the Warrant qualifies as tangible common equity. Information about the terms of these securities is provided in Note 10 to the Consolidated Financial Statements.

The terms of the Series A Preferred Stock call for the payment, if declared by the Board of Directors of First United Corporation, of a quarterly cash dividend on February 15<sup>th</sup>, May 15<sup>th</sup>, August 15<sup>th</sup> and November 15<sup>th</sup> of each year. At the request of the Reserve Bank, First United Corporation deferred the payment of cash dividends on the Series A Preferred Stock beginning with the payment that was due on November 15, 2010. As of March 31, 2013, this deferral election remained in effect and dividends of \$.4 million per quarterly dividend period continue to accrue. First United Corporation will be required to pay all accrued and unpaid dividends if and when the Board of Directors declares and pays the next quarterly cash dividend. Management cannot predict whether or when the Board of Directors will resume quarterly cash dividends on the Series A Preferred Stock. First United Corporation's ability to make dividend payments in the future will depend primarily on our earnings in future periods.

On December 15, 2010, also at the request of the Reserve Bank, the Board of Directors of First United Corporation elected to defer quarterly interest payments under the TPS Debentures beginning with the payments that were due in March 2011. As of March 31, 2013, this deferral election remained in effect and cumulative deferred

interest was approximately \$4.9 million, which has been fully accrued and must be paid in full when the Board of Directors elects to terminate the deferral. First United Corporation's ability to resume quarterly interest payments will depend primarily on our earnings in future periods. Accordingly, no assurance can be given as to if or when First United Corporation will resume the payment of interest under the TPS Debentures.

In connection with, and as a result of, the aforementioned deferrals, the Board of Directors of First United Corporation voted to suspend the declaration of quarterly cash dividends on the common stock until further notice. The payment of cash dividends on the common stock is at the discretion of the Board of Directors and is dependent on our earnings in future periods. In addition, cash dividends on the common stock may be paid only if all accrued and unpaid interest due under the TPS Debentures and all accrued and unpaid dividends due under the Series A Preferred Stock have been paid in full. There can be no assurance as to if or when First United Corporation will resume the payment of cash dividends on the common stock.

#### *Contractual Obligations, Commitments and Off-Balance Sheet Arrangements*

Loan commitments are made to accommodate the financial needs of our customers. Letters of credit commit us to make payments on behalf of customers when certain specified future events occur. The credit risks inherent in loan commitments and letters of credit are essentially the same as those involved in extending loans to customers, and these arrangements are subject to our normal credit policies. Loan commitments and letters of credit totaled \$81.9 million and \$1.2 million, respectively, at March 31, 2013, compared to \$87.1 million and \$1.3 million, respectively, at December 31, 2012. We are not a party to any other off-balance sheet arrangements.

See Note 11 to the consolidated financial statements presented elsewhere in this report for further disclosure on Borrowed Funds. There have been no other significant changes to contractual obligations as presented at December

31, 2012.

**Item 3. Quantitative and Qualitative Disclosures about Market Risk**

Our primary market risk is interest rate fluctuation and we have procedures in place to evaluate and mitigate this risk. This market risk and our procedures are described above in Item 2 of Part I of this report under the caption "*Market Risk and Interest Sensitivity*", and in Item 7 of Part II of First United Corporation's Annual Report on Form 10-K for the year ended December 31, 2012 under the caption "Market Risk and Interest Sensitivity". Management believes that no material changes in our procedures used to evaluate and mitigate these risks have occurred since December 31, 2012. We believe the investment portfolio restructuring has better positioned the Corporation for a rising interest rate environment.

56

**Item 4. Controls and Procedures**

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our reports filed under the Securities Exchange Act of 1934 with the SEC, such as this Quarterly Report, is recorded, processed, summarized and reported within the periods specified in those rules and forms, and that such information is accumulated and communicated to our management, including the Chief Executive Officer (“CEO”) and the Chief Financial Officer (“CFO”), as appropriate, to allow for timely decisions regarding required disclosure. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any system of controls is also based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Over time, controls may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate.

An evaluation of the effectiveness of these disclosure controls as of March 31, 2013 was carried out under the supervision and with the participation of Management, including the CEO and the CFO. Based on that evaluation, Management, including the CEO and the CFO, has concluded that our disclosure controls and procedures are, in fact, effective at the reasonable assurance level.

During the first three months of 2013, there was no change in our internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## **Part II. OTHER INFORMATION**

### **Item 1. Legal Proceedings**

None.

### **Item 1A. Risk Factors**

The risks and uncertainties to which our financial condition and operations are subject are discussed in detail in Item 1A of Part I of the Corporation's Annual Report on Form 10-K for the year ended December 31, 2012. Management does not believe that any material changes in our risk factors have occurred since December 31, 2012.

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

None.

### **Item 3. Defaults upon Senior Securities**

As previously reported in First United Corporation's SEC reports and as discussed in Item 7 of Part I of this report, the terms of First United Corporation's Series A Preferred Stock call for the payment, if declared by the Board of Directors of First United Corporation, of a quarterly cash dividend on February 15<sup>th</sup>, May 15<sup>th</sup>, August 15<sup>th</sup> and November 15<sup>th</sup> of each year. At the request of the Reserve Bank, First United Corporation has not declared or paid cash dividends on its Series A Preferred Stock since August 15, 2010. Dividends of \$.4 million per dividend period continue to accrue, aggregating \$4.0 million at March 31, 2013. First United Corporation will be required to pay all accrued and unpaid dividends if and when the Board of Directors declares the next quarterly cash dividend.

### **Item 4. Mine Safety Disclosures**

Not Applicable.

**Item 5. Other Information**

None.

**Item 6. Exhibits**

The exhibits filed or furnished with this quarterly report are listed in the Exhibit Index that follows the signatures, which index is incorporated herein by reference.

**SIGNATURES**

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

FIRST UNITED CORPORATION

Date: May 13, 2013 /s/ William B. Grant  
William B. Grant, Chairman of the Board and  
Chief Executive Officer  
(Principal Executive Officer)

Date May 13, 2013 /s/ Carissa L. Rodeheaver  
Carissa L. Rodeheaver,  
President, Chief Financial Officer, Treasurer and Secretary  
(Principal Accounting Officer)



EXHIBIT INDEX

| Exhibit | Description   |
|---------|---|
| 31.1    | Certifications of the Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act (filed herewith)  |
| 31.2    | Certifications of the Principal Accounting Officer pursuant to Section 302 of the Sarbanes-Oxley Act (filed herewith)                                       |
| 32      | Certification of the Principal Executive Officer and the Principal Accounting Office pursuant to Section 906 of the Sarbanes-Oxley Act (furnished herewith) |
| 101.INS | XBRL Instance Document (furnished herewith)   |
| 101.SCH | XBRL Taxonomy Extension Schema (furnished herewith)   |
| 101.CAL | XBRL Taxonomy Extension Calculation Linkbase (furnished herewith)   |
| 101.DEF | XBRL Taxonomy Extension Definition Linkbase (furnished herewith)  |
| 101.LAB | XBRL Taxonomy Extension Label Linkbase (furnished herewith)   |
| 101.PRE | XBRL Taxonomy Extension Presentation Linkbase (furnished herewith)  |

59