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Home Federal Bancorp, Inc.  
Form 10-Q  
November 08, 2012  
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 1934

For the quarterly period ended September 30, 2012

or

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 001-33795

HOME FEDERAL BANCORP, INC.

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(Exact name of registrant as specified in its charter)

Maryland  
(State or other jurisdiction of incorporation  
or organization)

68-0666697  
(I.R.S. Employer  
Identification Number)

500 12th Avenue South, Nampa, Idaho  
(Address of principal executive offices)

83651  
(Zip Code)

Registrant's telephone number, including area  
code:

(208) 466-4634

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

Yes ☒ 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 the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting

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company” in Rule 12b-2 of the Exchange Act.

|                         |                          |                           |                                     |
|-------------------------|--------------------------|---------------------------|-------------------------------------|
| Large accelerated filer | <input type="checkbox"/> | Accelerated filer         | <input checked="" type="checkbox"/> |
| Non-accelerated filer   | <input type="checkbox"/> | Smaller reporting company | <input type="checkbox"/>            |

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: Common Stock, \$.01 par value per share, 14,536,829 shares outstanding as of November 2, 2012.

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HOME FEDERAL BANCORP, INC.  
FORM 10-Q  
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## Item 1. Financial Statements

HOME FEDERAL BANCORP, INC. AND SUBSIDIARY  
CONSOLIDATED BALANCE SHEETS

(In thousands, except share data) (Unaudited)

|  | September<br>30, 2012 | December<br>31, 2011 |
|--|-----------------------|----------------------|
| <b>ASSETS</b>  |                       |                      |
| Cash and cash equivalents  | \$86,234              | \$144,293            |
| Investments available-for-sale, at fair value  | 444,449               | 399,877              |
| Loans and leases receivable, net of allowance for loan and lease losses of \$12,588 and \$14,171 | 420,232               | 449,908              |
| Accrued interest receivable  | 3,062                 | 2,857                |
| Federal Deposit Insurance Corporation ("FDIC") indemnification receivable, net                   | 14,024                | 23,676               |
| Bank owned life insurance  | 15,815                | 15,450               |
| Real estate owned and other repossessed assets ("REO")   | 14,185                | 19,827               |
| Federal Home Loan Bank ("FHLB") stock, at cost   | 17,559                | 17,717               |
| Property and equipment, net  | 29,672                | 31,522               |
| Core deposit intangible  | 2,653                 | 3,086                |
| Other assets   | 12,302                | 8,221                |
| <b>TOTAL ASSETS</b>  | <b>\$1,060,187</b>    | <b>\$1,116,434</b>   |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>  |                       |                      |
| <b>LIABILITIES</b>   |                       |                      |
| Deposit accounts:  |                       |                      |
| Noninterest-bearing demand   | \$141,381             | \$127,553            |
| Interest-bearing demand  | 245,901               | 249,215              |
| Money market   | 174,008               | 178,377              |
| Savings  | 80,050                | 78,492               |
| Certificates   | 217,042               | 272,462              |
| Total deposit accounts   | 858,382               | 906,099              |
| Advances by borrowers for taxes and insurance  | 1,321                 | 358                  |
| Accrued interest payable   | 173                   | 219                  |
| Repurchase agreements  | 4,758                 | 4,913                |
| Deferred compensation  | 6,057                 | 5,871                |
| Other liabilities  | 5,854                 | 7,704                |
| <b>Total liabilities</b>   | <b>876,545</b>        | <b>925,164</b>       |
| <b>STOCKHOLDERS' EQUITY</b>  |                       |                      |
| Serial preferred stock, \$.01 par value; 10,000,000 authorized; issued and outstanding: none     | --                    | --                   |
| Common stock, \$.01 par value; 90,000,000 authorized; issued and outstanding:                    | 145                   | 157                  |
| Sep. 30, 2012 - 17,512,197 issued; 14,536,029 outstanding  |                       |                      |
| Dec. 31, 2011 - 17,512,197 issued; 15,664,706 outstanding  |                       |                      |

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|   |                    |                    |
|---|--------------------|--------------------|
| Additional paid-in capital                              | 132,523            | 143,280            |
| Retained earnings                                       | 48,547             | 49,443             |
| Unearned shares issued to employee stock ownership plan | (7,013 )           | (7,581 )           |
| Accumulated other comprehensive income                  | 9,440              | 5,971              |
| Total stockholders' equity                              | 183,642            | 191,270            |
| <b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>       | <b>\$1,060,187</b> | <b>\$1,116,434</b> |

See accompanying notes.

HOME FEDERAL BANCORP, INC. AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except share data) (Unaudited)

|   | Three Months Ended<br>September 30, |            | Nine Months Ended<br>September 30, |            |
|---|-------------------------------------|------------|------------------------------------|------------|
|   | 2012                                | 2011       | 2012                               | 2011       |
| Interest income:                                    |                                     |            |                                    |            |
| Loans and leases                                    | \$10,150                            | \$15,416   | \$30,400                           | \$32,635   |
| Investments   | 2,249                               | 2,116      | 6,662                              | 6,822      |
| Other interest                                      | 38                                  | 115        | 179                                | 367        |
| Total interest income                               | 12,437                              | 17,647     | 37,241                             | 39,824     |
| Interest expense:                                   |                                     |            |                                    |            |
| Deposits  | 891                                 | 1,381      | 2,984                              | 4,525      |
| FHLB advances and other borrowings                  | 17                                  | 508        | 54                                 | 1,613      |
| Total interest expense                              | 908                                 | 1,889      | 3,038                              | 6,138      |
| Net interest income                                 | 11,529                              | 15,758     | 34,203                             | 33,686     |
| Provision for loan losses                           | 105                                 | 2,585      | (1,112 )                           | 8,396      |
| Net interest income after provision for loan losses | 11,424                              | 13,173     | 35,315                             | 25,290     |
| Noninterest income:                                 |                                     |            |                                    |            |
| Service charges and fees                            | 2,110                               | 2,685      | 6,491                              | 7,363      |
| Gain on sale of loans                               | --                                  | 194        | 1                                  | 501        |
| Gain on sale of investments                         | 79                                  | 607        | 1,217                              | 607        |
| Gain on sale of fixed assets and REO                | 182                                 | 61         | 554                                | 205        |
| FDIC indemnification recovery (provision)           | 50                                  | 2,078      | (1,180 )                           | 7,317      |
| Impairment of FDIC indemnification asset            | (2,994 )                            | (6,915 )   | (8,042 )                           | (5,911 )   |
| Prepayment penalty on borrowings                    | --                                  | (2,007 )   | --                                 | (2,007 )   |
| Other   | 222                                 | 238        | 637                                | 667        |
| Total noninterest income                            | (351 )                              | (3,059 )   | (322 )                             | 8,742      |
| Noninterest expense:                                |                                     |            |                                    |            |
| Compensation and benefits                           | 5,717                               | 7,081      | 18,029                             | 21,042     |
| Occupancy and equipment                             | 1,466                               | 1,656      | 4,543                              | 5,051      |
| Data processing                                     | 920                                 | 964        | 2,867                              | 3,066      |
| Advertising   | 219                                 | 474        | 596                                | 909        |
| Postage and supplies                                | 210                                 | 351        | 763                                | 998        |
| Professional services                               | 678                                 | 587        | 1,947                              | 2,486      |
| Insurance and taxes                                 | 503                                 | 502        | 1,585                              | 2,244      |
| Amortization of intangibles                         | 137                                 | 168        | 433                                | 530        |
| Provision for REO                                   | 56                                  | 86         | 454                                | 739        |
| Other   | 580                                 | 1,675      | 1,335                              | 2,626      |
| Total noninterest expense                           | 10,486                              | 13,544     | 32,552                             | 39,691     |
| Income (loss) before income taxes                   | 587                                 | (3,430 )   | 2,441                              | (5,659 )   |
| Income tax provision (benefit)                      | 265                                 | (1,413 )   | 858                                | (2,361 )   |
| Net income (loss)                                   | \$322                               | \$(2,017 ) | \$1,583                            | \$(3,298 ) |

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Earnings (loss) per common share:

|         |        |         |          |         |   |
|---------|--------|---------|----------|---------|---|
| Basic   | \$0.02 | \$(0.13 | ) \$0.11 | \$(0.21 | ) |
| Diluted | 0.02   | (0.13   | ) 0.11   | (0.21   | ) |

Weighted average number of shares outstanding:

|         |            |            |            |            |
|---------|------------|------------|------------|------------|
| Basic   | 14,109,468 | 15,199,958 | 14,505,210 | 15,425,397 |
| Diluted | 14,117,621 | 15,199,958 | 14,505,210 | 15,425,397 |

|                               |        |         |        |         |
|-------------------------------|--------|---------|--------|---------|
| Dividends declared per share: | \$0.06 | \$0.055 | \$0.17 | \$0.165 |
|-------------------------------|--------|---------|--------|---------|

See accompanying notes.

HOME FEDERAL BANCORP, INC. AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)  
(In thousands) (Unaudited)

|   | Three Months Ended<br>September 30, |            | Nine Months Ended<br>September 30, |            |
|---|-------------------------------------|------------|------------------------------------|------------|
|   | 2012                                | 2011       | 2012                               | 2011       |
| Net income (loss)   | \$322                               | \$(2,017 ) | \$1,583                            | \$(3,298 ) |
| Other comprehensive income:   |                                     |            |                                    |            |
| Change in unrealized holding gain on investments<br>available-for-sale, net of taxes of \$1,282, \$1,085, \$2,687,<br>and \$2,992, respectively | 2,009                               | 1,701      | 4,212                              | 4,690      |
| Adjustment for realized gains on sales of investments, net of<br>taxes of (\$31), (\$236), (\$474) and (\$236), respectively                    | (48 )                               | (371 )     | (743 )                             | (371 )     |
| Other comprehensive income  | 1,961                               | 1,330      | 3,469                              | 4,319      |
| Comprehensive income (loss)   | \$2,283                             | \$(687 )   | \$5,052                            | \$1,021    |

See accompanying notes.



HOME FEDERAL BANCORP, INC. AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY  
(In thousands, except share data) (Unaudited)

|  | Common Stock |        | Additional | Retained | Unearned   | Accumulated   |           |
|--|--------------|--------|------------|----------|------------|---------------|-----------|
|  | Shares       | Amount | Paid-In    | Earnings | Shares     | Other         | Total     |
|  |              |        | Capital    |          | Issued to  | Comprehensive |           |
|  |              |        |            |          | ESOP       | Income        |           |
| Balance at January 1, 2012   | 15,664,706   | \$ 157 | \$143,280  | \$49,443 | \$(7,581 ) | \$ 5,971      | \$191,270 |
| Restricted stock issued, net of forfeitures and redemption for taxes | 39,836       |        | (38 )      |          |            |               | (38)      |
| ESOP shares committed to be released                                 |              |        | 24         |          | 568        |               | 592       |
| Share-based compensation   |              |        | 758        |          |            |               | 758       |
| Stock repurchase   | (1,168,513 ) | (12 )  | (11,452 )  |          |            |               | (11,464)  |
| Dividends paid (\$0.17 per share)                                    |              |        |            |          |            |               |           |
|  |              |        |            | (2,479 ) |            |               | (2,479)   |
| Tax adjustment from equity compensation plans                        |              |        | (49 )      |          |            |               | (49)      |
| Net income   |              |        |            | 1,583    |            |               | 1,583     |
| Other comprehensive income   |              |        |            |          |            | 3,469         | 3,469     |
| Balance at September 30, 2012  | 14,536,029   | \$ 145 | \$132,523  | \$48,547 | \$(7,013 ) | \$ 9,440      | \$183,642 |

See accompanying notes.

HOME FEDERAL BANCORP, INC. AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(In thousands) (Unaudited)

Nine Months Ended  
September 30,  
2012                      2011

**CASH FLOWS FROM OPERATING ACTIVITIES:**

|  |          |            |
|--|----------|------------|
| Net income (loss)  | \$1,583  | \$(3,298 ) |
| Adjustments to reconcile net income (loss) to cash provided by operating activities: |          |            |
| Depreciation and amortization  | 2,292    | 1,840      |
| Amortization of core deposit intangible  | 433      | 530        |
| Impairment of FDIC indemnification receivable  | 8,042    | 5,911      |
| Net amortization of premiums and discounts on investments                            | 4,311    | 4,381      |
| Gain on sale of loans, net   | (1 )     | (501 )     |
| Gain on sale of investments available-for-sale, net                                  | (1,217 ) | (607 )     |
| Gain on sale of fixed assets and repossessed assets, net                             | (554 )   | (205 )     |
| ESOP shares committed to be released   | 592      | 896        |
| Share based compensation expense   | 758      | 659        |
| Provision for loan losses  | (1,112 ) | 8,396      |
| Valuation provision on real estate and other property owned                          | 454      | 739        |
| Accrued deferred compensation expense, net   | 186      | 141        |
| Net deferred loan fees   | 203      | 287        |
| Deferred income tax provision  | (4,495 ) | (7,400 )   |
| Proceeds from sale of loans held for sale  | 1        | 17,733     |
| Originations of loans held for sale  | --       | (16,058 )  |
| Net increase in cash surrender value of bank owned life insurance                    | (365 )   | (307 )     |
| Change in assets and liabilities:  |          |            |
| Interest receivable  | (205 )   | 105        |
| Other assets   | (2,315 ) | 1,057      |
| Interest payable   | (46 )    | (329 )     |
| Other liabilities  | (1,938 ) | 1,919      |
| Net cash provided from operating activities  | 6,607    | 15,889     |

**CASH FLOWS FROM INVESTING ACTIVITIES:**

|  |            |           |
|--|------------|-----------|
| Principal repayments, maturities and calls of investments available-for-sale | 77,602     | 88,642    |
| Proceeds from sales of investments available-for-sale                        | 62,849     | 28,172    |
| Purchase of investments available-for-sale                                   | (182,435 ) | (68,279 ) |
| Proceeds from sale of FHLB stock   | 158        | --        |
| Reimbursement of loan losses under loss share agreement                      | 2,932      | 35,009    |
| Net decrease in loans  | 28,493     | 78,962    |
| Purchase of loans  | (7,711 )   | --        |
| Proceeds from sales of fixed assets and repossessed assets                   | 14,980     | 17,921    |
| Purchases of property and equipment  | (682 )     | (7,422 )  |
| Net cash provided from (used by) investing activities                        | (3,814 )   | 173,005   |

**CASH FLOWS FROM FINANCING ACTIVITIES:**

|                          |           |            |
|--------------------------|-----------|------------|
| Net decrease in deposits | (47,717 ) | (146,103 ) |
|--------------------------|-----------|------------|

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|  |               |               |
|--|---------------|---------------|
| Net increase in advances by borrowers for taxes and insurance  | 963           | 794           |
| Repayment of FHLB borrowings                                   | --            | (52,248 )     |
| Net decrease in securities sold under obligation to repurchase | (155 )        | (3,228 )      |
| Proceeds from exercise of stock options                        | --            | 356           |
| Repurchases of common stock                                    | (11,464 )     | (7,420 )      |
| Dividends paid   | (2,479 )      | (2,557 )      |
| Net cash used by financing activities                          | (60,852 )     | (210,406 )    |
| <br>NET DECREASE IN CASH AND CASH EQUIVALENTS                  | <br>(58,059 ) | <br>(21,512 ) |
| CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD                 | 144,293       | 212,246       |
| CASH AND CASH EQUIVALENTS, END OF PERIOD                       | \$86,234      | \$190,734     |

(Continued)

See accompanying notes.

HOME FEDERAL BANCORP, INC. AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF CASH FLOWS (continued)  
(In thousands) (Unaudited)

Nine Months Ended  
September 30,  
2012                      2011

SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:

Cash paid (received) during the period for:

|          |         |         |
|----------|---------|---------|
| Interest | \$3,084 | \$6,467 |
| Taxes    | 7,489   | 208     |

NONCASH INVESTING AND FINANCING ACTIVITIES:

|  |         |          |
|--|---------|----------|
| Acquisition of real estate owned and other assets in settlement of loans | \$9,851 | \$16,547 |
| Fair value adjustment to investments available-for-sale, net of taxes    | 3,469   | 4,318    |

See accompanying notes.

HOME FEDERAL BANCORP, INC. AND SUBSIDIARY  
SELECTED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

Note 1 - Basis of Presentation

The consolidated financial statements presented in this report include the accounts of Home Federal Bancorp, Inc., a Maryland corporation (the “Company”), and its wholly-owned subsidiary, Home Federal Bank (the “Bank”), which is a state-chartered commercial bank headquartered in Nampa, Idaho. As used throughout this report, the term the “Company” refers to Home Federal Bancorp, Inc., and its consolidated subsidiary, unless the context otherwise requires.

The consolidated financial statements of the Company have been prepared in conformity with U.S. generally accepted accounting principles for interim financial information and are unaudited. All significant intercompany transactions and balances have been eliminated. In the opinion of the Company’s management, all adjustments consisting of normal recurring adjustments necessary for a fair presentation of the financial condition and results of operations for the interim periods included herein have been made. Operating results for the three and nine month periods ended September 30, 2012, are not necessarily indicative of the results that may be expected for future periods.

On January 24, 2012, the Company reported its decision to change its fiscal year end to December 31 from a fiscal year ending on September 30. This change in fiscal year end makes the Company’s year-end coincide with the regulatory reporting periods now effective with the Company’s reorganization to a bank holding company and the Bank’s conversion to a commercial bank that occurred on May 31, 2011. As a result of the change in fiscal year, the Company filed a transition report on Form 10-QT covering the transition period from October 1, 2011 to December 31, 2011. References the Company makes to a particular year (for example, 2010) in this report applies to the Company’s fiscal year and not the calendar year, unless otherwise noted.

On July 30, 2010, the Bank entered into a purchase and assumption agreement with the FDIC to assume all of the deposits and acquire certain assets of LibertyBank, headquartered in Eugene, Oregon (the “LibertyBank Acquisition”). In August 2009, the Bank entered into a purchase and assumption agreement with the FDIC to assume all of the deposits and certain assets of Community First Bank, headquartered in Prineville, Oregon (the “CFB Acquisition”). All of the loans purchased in the CFB Acquisition and the majority of loans and leases purchased in the LibertyBank Acquisition are included under the loss sharing agreements with the FDIC and are referred to as “covered loans.” Real estate owned and repossessed assets (“REO”) acquired in the CFB Acquisition and the LibertyBank Acquisition that are also included in the loss sharing agreements are referred to as “covered REO.” The covered loans and covered REO are collectively referred to as “covered assets.” Loans and foreclosed and repossessed assets not subject to loss sharing agreements with the FDIC are referred to as “noncovered loans” or “noncovered assets.”

Certain information and note disclosures normally included in the Company’s annual consolidated financial statements have been condensed or omitted. Therefore, these consolidated financial statements and notes thereto should be read in conjunction with the audited financial statements and notes included in the Company’s Annual Report on Form 10-K for the fiscal year ended September 30, 2011 (“2011 Form 10-K”), filed with the Securities and Exchange Commission (“SEC”) on December 14, 2011.

Certain reclassifications have been made to prior year’s financial statements in order to conform to the current year presentation. The reclassifications had no effect on previously reported net income (loss) or equity.

Note 2 - Recent Accounting Pronouncements

In October 2011, Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2012-06, Business Combinations (Topic 805): Subsequent Accounting for an Indemnification Asset Recognized at the

Acquisition Date as a Result of a Government-Assisted Acquisition of a Financial Institution. ASU 2012-06 addresses the diversity in practice about how to interpret the terms “on the same basis” and “contractual limitations” when subsequently measuring an indemnification asset. This update is effective for fiscal years and interim periods

beginning on or after December 15, 2012. Early adoption is permitted, and adoption should be applied prospectively to indemnification assets existing as of the date of adoption. This update is not expected to have a significant impact on the Company's Consolidated Financial Statements at the date of adoption.

In December 2011, the FASB issued ASU 2011-12, Comprehensive Income (Topic 220) – Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05. ASU 2011-12 defers changes in ASU 2011-05 that relate to the presentation of reclassification adjustments to allow the FASB time to redeliberate whether to require presentation of such adjustments on the face of the financial statements to show the effects of reclassifications out of accumulated other comprehensive income on the components of net income and other comprehensive income. ASU 2011-12 allows entities to continue to report reclassifications out of accumulated other comprehensive income consistent with the presentation requirements in effect before ASU 2011-05. All other requirements in ASU 2011-05 are not affected by ASU 2011-12. ASU 2011-12 did not have a significant impact on the Company's Consolidated Financial Statements.

In May 2011, the FASB issued ASU 2011-04, Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs (International Financial Reporting Standards). This guidance is effective for the first interim or annual period beginning on or after December 15, 2011, and will be applied prospectively beginning in the period of adoption. The amendments change the wording used to describe requirements for measuring fair value under U.S. GAAP to be more consistent with IFRSs. The adoption of this guidance did not have a material effect on the Company's Consolidated Financial Statements, however, the additional disclosures are included in this Form 10-Q.

### Note 3 - Earnings (Loss) Per Share

The Company has granted stock compensation awards with non-forfeitable dividend rights, which are considered participating securities. Accordingly, earnings (loss) per share ("EPS") is computed using the two-class method as required by ASC 260-10-45. Basic EPS is computed by dividing net income (or loss) allocated to common stock by the weighted average number of common shares outstanding during the period which excludes the participating securities. Diluted EPS includes the dilutive effect of additional potential common shares from stock compensation awards, but excludes awards considered participating securities. ESOP shares are not considered outstanding for EPS until they are committed to be released. The following table presents the computation of basic and diluted EPS for the periods indicated (in thousands, except share and per share data):

|  | Three Months Ended<br>September 30, |            | Nine Months Ended<br>September 30, |            |
|--|-------------------------------------|------------|------------------------------------|------------|
|  | 2012                                | 2011       | 2012                               | 2011       |
| Net income (loss)                                    | \$322                               | \$(2,017)  | \$1,583                            | \$(3,298)  |
| Allocated to participating securities                | (3)                                 | 16         | (14)                               | 28         |
| Net income (loss) allocated to common shareholders   | \$319                               | \$(2,001)  | \$1,569                            | \$(3,270)  |
| Weighted average common shares outstanding, gross    | 14,964,693                          | 16,124,943 | 15,377,013                         | 16,383,706 |
| Less: Average unearned ESOP shares                   | (729,749)                           | (795,718)  | (749,210)                          | (823,471)  |
| Less: Average participating securities               | (125,476)                           | (129,267)  | (122,593)                          | (134,838)  |
| Weighted average common shares outstanding, net      | 14,109,468                          | 15,199,958 | 14,505,210                         | 15,425,397 |
| Net effect of dilutive stock options                 | 8,153                               | --         | --                                 | --         |
| Weighted average shares and common stock equivalents | 14,117,621                          | 15,199,958 | 14,505,210                         | 15,425,397 |

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Income (loss) per common share:

|         |        |         |          |         |   |
|---------|--------|---------|----------|---------|---|
| Basic   | \$0.02 | \$(0.13 | ) \$0.11 | \$(0.21 | ) |
| Diluted | 0.02   | (0.13   | ) 0.11   | (0.21   | ) |

Options excluded from the calculation due to their  
anti-dilutive effect on EPS

968,092      904,853      968,092      904,853



# Note 4 - Investments

Investments available-for-sale consisted of the following at the dates indicated (dollars in thousands):

|  | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair Value | Percent of<br>Total |   |
|--|-------------------|------------------------------|-------------------------------|------------|---------------------|---|
| September 30, 2012   |                   |                              |                               |            |                     |   |
| Obligations of U.S. Government-sponsored enterprises ("GSE") | \$57,801          | \$1,388                      | \$--                          | \$59,189   | 13.3                | % |
| U. S. Treasury bonds   | 9,410             | 425                          | --                            | 9,835      | 2.2                 |   |
| Obligations of states and political subdivisions             | 40,670            | 2,038                        | (88 )                         | 42,620     | 9.6                 |   |
| Mortgage-backed securities, GSE-issued                       | 320,795           | 11,827                       | (124 )                        | 332,498    | 74.8                |   |
| Mortgage-backed securities, private label                    | 310               | --                           | (3 )                          | 307        | 0.1                 |   |
| Total  | \$428,986         | \$15,678                     | \$(215 )                      | \$444,449  | 100.0               | % |
| December 31, 2011  |                   |                              |                               |            |                     |   |
| Obligations of U.S. GSE                                      | \$65,345          | \$650                        | \$(11 )                       | \$65,984   | 16.5                | % |
| Obligations of states and political subdivisions             | 20,850            | 992                          | (33 )                         | 21,809     | 5.4                 |   |
| Corporate note, FDIC-guaranteed                              | 1,005             | 2                            | --                            | 1,007      | 0.3                 |   |
| Mortgage-backed securities, GSE-issued                       | 302,539           | 8,480                        | (253 )                        | 310,766    | 77.7                |   |
| Mortgage-backed securities, private label                    | 357               | --                           | (46 )                         | 311        | 0.1                 |   |
| Total  | \$390,096         | \$10,124                     | \$(343 )                      | \$399,877  | 100.0               | % |

For the quarter ended September 30, 2012, proceeds from sales of investments available-for-sale amounted to \$6.8 million. Gross realized gains on these sales totaled \$79,000, partially offset by a tax provision of \$31,000. There were no gross realized losses during the period. For the nine months ended September 30, 2012, proceeds from sales of investments available-for-sale were \$62.8 million. Gross realized gains on these sales totaled \$1.2 million, partially offset by a tax provision of \$474,000. There were no gross realized losses during the period. We did not sell any investments during the three months ended March 31, 2011 or June 30, 2011; however, during the three months ended September 30, 2011, we sold \$28.2 million of investments for a gross gain of \$607,000. There were no gross realized losses during that period.

The fair value of impaired investments, the amount of unrealized losses and the length of time these unrealized losses existed for the periods indicated were as follows (in thousands):

|  | Less Than 12 Months |                      | 12 Months or Longer |                      | Total      |                      |
|--|---------------------|----------------------|---------------------|----------------------|------------|----------------------|
|  | Fair Value          | Unrealized<br>Losses | Fair Value          | Unrealized<br>Losses | Fair Value | Unrealized<br>Losses |
| September 30, 2012                               |                     |                      |                     |                      |            |                      |
| Obligations of states and political subdivisions | \$7,338             | \$(88 )              | \$--                | \$--                 | \$7,338    | \$(88 )              |
| Mortgage-backed securities, GSE-issued           | 10,442              | (124 )               | 19                  | --                   | 10,461     | (124 )               |
| Mortgage-backed securities, private label        | --                  | --                   | 307                 | (3 )                 | 307        | (3 )                 |

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|  |          |         |           |        |            |         |   |
|--|----------|---------|-----------|--------|------------|---------|---|
| Total  | \$17,780 | \$(212) | ) \$326   | \$(3)  | ) \$18,106 | \$(215) | ) |
| December 31, 2011                                |          |         |           |        |            |         |   |
| Obligations of U.S. GSE                          | \$1,739  | \$(11)  | ) \$--    | \$--   | \$1,739    | \$(11)  | ) |
| Obligations of states and political subdivisions | 2,802    | (33)    | ) --      | --     | 2,802      | (33)    | ) |
| Mortgage-backed securities, GSE-issued           | 38,732   | (245)   | ) 4,010   | (8)    | ) 42,742   | (253)   | ) |
| Mortgage-backed securities, private label        | --       | --      | ) 311     | (46)   | ) 311      | (46)    | ) |
| Total  | \$43,273 | \$(289) | ) \$4,321 | \$(54) | ) \$47,594 | \$(343) | ) |

Management has evaluated these investments and has determined that the decline in fair value is not other than temporary. These investments have contractual maturity dates and management believes it is probable that principal and interest balances on these investments will be collected based on the performance, underwriting, credit support and vintage of the loans underlying the investments. However, continued deteriorating economic conditions may result in degradation in the performance of the loans underlying these investments in the future. The Company has the ability and intent to hold these investments for a reasonable period of time for a forecasted recovery of the amortized cost. The Company does not intend to sell these investments and it is not likely that the Company would be required to sell investments in an unrealized loss position before recovery of its cost basis.

The contractual maturities of investments available-for-sale at the dates indicated are shown below (in thousands). Expected maturities may differ from the contractual maturities of such investments because borrowers have the right to prepay obligations without prepayment penalties.

|  | September 30, 2012 |            | December 31, 2011 |            |
|--|--------------------|------------|-------------------|------------|
|  | Amortized<br>Cost  | Fair Value | Amortized<br>Cost | Fair Value |
| Due within one year                    | \$ 14,168          | \$ 14,206  | \$ 13,418         | \$ 13,455  |
| Due after one year through five years  | 12,283             | 12,418     | 23,982            | 24,175     |
| Due after five years through ten years | 21,417             | 22,605     | 12,457            | 13,046     |
| Due after ten years                    | 60,013             | 62,415     | 37,343            | 38,124     |
| Mortgage-backed securities             | 321,105            | 332,805    | 302,896           | 311,077    |
| Total                                  | \$ 428,986         | \$ 444,449 | \$ 390,096        | \$ 399,877 |

As of September 30, 2012 and December 31, 2011, the Bank pledged investments for the following obligations (in thousands):

|  | September 30, 2012 |               | December 31, 2011 |               |
|--|--------------------|---------------|-------------------|---------------|
|  | Amortized<br>Cost  | Fair<br>Value | Amortized<br>Cost | Fair<br>Value |
| FHLB borrowing line of credit                  | \$ 25,985          | \$ 28,332     | \$ 33,782         | \$ 36,460     |
| Federal Reserve Bank                           | 1,305              | 1,380         | 1,787             | 1,874         |
| Repurchase agreements                          | 5,307              | 5,633         | 7,458             | 7,858         |
| Deposits of municipalities and public<br>units | 11,364             | 12,239        | 15,499            | 16,513        |
| Total  | \$ 43,961          | \$ 47,584     | \$ 58,526         | \$ 62,705     |

# Note 5 - Loans Receivable and Allowance for Loan Losses

Loans receivable at the dates indicated are summarized by collateral type as follows (dollars in thousands):

|                                 | September 30, 2012 |                     |   | December 31, 2011 |                     |   |
|---------------------------------|--------------------|---------------------|---|-------------------|---------------------|---|
|                                 | Amount             | Percent<br>of Gross |   | Amount            | Percent<br>of Gross |   |
| Real estate:                    |                    |                     |   |                   |                     |   |
| One-to-four family residential  | \$95,070           | 22.0                | % | \$115,403         | 24.8                | % |
| Multifamily residential         | 35,449             | 8.2                 |   | 21,036            | 4.5                 |   |
| Commercial real estate          | 184,464            | 42.6                |   | 206,215           | 44.4                |   |
| Total real estate               | 314,983            | 72.8                |   | 342,654           | 73.7                |   |
| Real estate construction:       |                    |                     |   |                   |                     |   |
| One-to-four family residential  | 13,627             | 3.1                 |   | 9,355             | 2.0                 |   |
| Multifamily residential         | 98                 | --                  |   | --                | --                  |   |
| Commercial and land development | 25,914             | 6.0                 |   | 16,928            | 3.6                 |   |
| Total real estate construction  | 39,639             | 9.1                 |   | 26,283            | 5.6                 |   |
| Consumer:                       |                    |                     |   |                   |                     |   |
| Home equity                     | 43,220             | 10.0                |   | 47,192            | 10.2                |   |
| Automobile                      | 940                | 0.2                 |   | 946               | 0.2                 |   |
| Other consumer                  | 3,797              | 0.9                 |   | 4,580             | 1.0                 |   |
| Total consumer                  | 47,957             | 11.1                |   | 52,718            | 11.4                |   |
| Commercial business             | 29,356             | 6.8                 |   | 40,953            | 8.8                 |   |
| Leases                          | 771                | 0.2                 |   | 2,159             | 0.5                 |   |
| Gross loans                     | 432,706            | 100.0               | % | 464,767           | 100.0               | % |
| Deferred loan costs (fees), net | 114                |                     |   | (688              | )                   |   |
| Allowance for loan losses       | (12,588            | )                   |   | (14,171           | )                   |   |
| Loans receivable, net           | \$420,232          |                     |   | \$449,908         |                     |   |

The following tables present loans at their recorded investment; therefore, the balances in the tables below may differ from the loan portfolio table above. Recorded investment includes the unpaid principal balance or the carrying amount of loans plus accrued interest less charge offs and net deferred loan fees. Accrued interest on loans was \$1.2 million and \$1.3 million as of September 30, 2012 and December 31, 2011, respectively.

Delinquent and nonaccrual loans. The following tables present the recorded investment in nonperforming loans and an aging of performing loans by class as of September 30, 2012 and December 31, 2011 (in thousands):

September 30, 2012

| Nonperforming Loans             |          |       |          |                  |            |           |             |
|---------------------------------|----------|-------|----------|------------------|------------|-----------|-------------|
| Past Due 90 or More Days, Still |          |       |          | Loans Delinquent |            | Loans Not |             |
| Nonaccrual                      | Accruing | Total |          | 30-59 Days       | 60-89 Days | Past Due  | Total Loans |
| Noncovered loans                |          |       |          |                  |            |           |             |
| Real estate:                    |          |       |          |                  |            |           |             |
| One-to-four family residential  | \$ 3,671 | \$ -- | \$ 3,671 | \$ 3             | \$ 110     | \$ 81,290 | \$ 85,074   |
| Multifamily residential         | 839      | --    | 839      | --               | --         | 30,837    | 31,676      |
| Commercial real estate          | 7,859    | --    | 7,859    | 309              | --         | 125,308   | 133,476     |
| Total real estate               | 12,369   | --    | 12,369   | 312              | 110        | 237,435   | 250,226     |
| Real estate construction:       |          |       |          |                  |            |           |             |
| One-to-four family residential  | 613      | --    | 613      | --               | --         | 13,014    | 13,627      |
| Multifamily residential         | --       | --    | --       | --               | --         | 98        | 98          |
| Commercial real estate          | 253      | --    | 253      | --               | --         | 19,170    | 19,423      |
| Total real estate construction  | 866      | --    | 866      | --               | --         | 32,282    | 33,148      |
| Consumer:                       |          |       |          |                  |            |           |             |
| Home equity                     | 693      | --    | 693      | 27               | --         | 31,845    | 32,565      |
| Automobile                      | --       | --    | --       | --               | --         | 709       | 709         |
| Other consumer                  | 149      | --    | 149      | 1                | 3          | 2,879     | 3,032       |
| Total consumer                  | 842      | --    | 842      | 28               | 3          | 35,433    | 36,306      |
| Commercial business             | 370      | --    | 370      | 3                | --         | 14,569    | 14,942      |
| Leases                          | --       | --    | --       | --               | --         | 175       | 175         |
| Total noncovered loans          | 14,447   | --    | 14,447   | 343              | 113        | 319,894   | 334,797     |
| Covered loans                   |          |       |          |                  |            |           |             |
| Real estate:                    |          |       |          |                  |            |           |             |
| One-to-four family residential  | 348      | --    | 348      | --               | --         | 9,726     | 10,074      |
| Multifamily residential         | --       | --    | --       | --               | --         | 3,772     | 3,772       |
| Commercial real estate          | 5,934    | --    | 5,934    | 226              | --         | 44,827    | 50,987      |
| Total real estate               | 6,282    | --    | 6,282    | 226              | --         | 58,325    | 64,833      |
| Real estate construction:       |          |       |          |                  |            |           |             |
| Commercial real estate          | 254      | --    | 254      | --               | --         | 6,238     | 6,492       |

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|                                |           |       |           |        |        |            |            |
|--------------------------------|-----------|-------|-----------|--------|--------|------------|------------|
| Total real estate construction | 254       | --    | 254       | --     | --     | 6,238      | 6,492      |
| Consumer:                      |           |       |           |        |        |            |            |
| Home equity                    | 89        | --    | 89        | --     | --     | 10,715     | 10,804     |
| Automobile                     | --        | --    | --        | --     | --     | 231        | 231        |
| Other consumer                 | --        | --    | --        | 23     | --     | 772        | 795        |
| Total consumer                 | 89        | --    | 89        | 23     | --     | 11,718     | 11,830     |
| Commercial business            |           |       |           |        |        |            |            |
| Leases                         | 7         | --    | 7         | --     | --     | 15,449     | 15,456     |
| Total covered loans            | 6,632     | --    | 6,632     | 249    | --     | 92,326     | 99,207     |
| Total gross loans              | \$ 21,079 | \$ -- | \$ 21,079 | \$ 592 | \$ 113 | \$ 412,220 | \$ 434,004 |

December 31, 2011

| Nonperforming Loans            |          |          |          |        |           |            |  |
|--------------------------------|----------|----------|----------|--------|-----------|------------|--|
| Past Due                       |          |          |          |        |           |            |  |
| 90                             |          |          |          |        |           |            |  |
| or More                        |          |          |          |        |           |            |  |
| Days,                          |          |          |          |        |           |            |  |
| Still                          |          |          |          |        |           |            |  |
| Loans Delinquent 30-59 Days    |          |          |          |        |           |            |  |
| Loans Delinquent 60-89 Days    |          |          |          |        |           |            |  |
| Loans Not Past Due             |          |          |          |        |           |            |  |
| Total Loans                    |          |          |          |        |           |            |  |
| Nonaccrual                     | Accruing | Total    |          |        |           |            |  |
| Noncovered loans               |          |          |          |        |           |            |  |
| Real estate:                   |          |          |          |        |           |            |  |
| One-to-four family residential |          |          |          |        |           |            |  |
| \$ 5,446                       | \$ --    | \$ 5,446 | \$ 1,435 | \$ 149 | \$ 96,307 | \$ 103,337 |  |
| Multifamily residential        |          |          |          |        |           |            |  |
| --                             | --       | --       | --       | --     | 13,184    | 13,184     |  |
| Commercial real estate         |          |          |          |        |           |            |  |
| 7,601                          | --       | 7,601    | --       | --     | 137,480   | 145,081    |  |
| Total real estate              |          |          |          |        |           |            |  |
| 13,047                         | --       | 13,047   | 1,435    | 149    | 246,971   | 261,602    |  |
| Real estate construction:      |          |          |          |        |           |            |  |
| One-to-four family residential |          |          |          |        |           |            |  |
| 415                            | --       | 415      | --       | --     | 7,921     | 8,336      |  |
| Commercial real estate         |          |          |          |        |           |            |  |
| 1,132                          | --       | 1,132    | --       | --     | 8,778     | 9,910      |  |
| Total real estate construction |          |          |          |        |           |            |  |
| 1,547                          | --       | 1,547    | --       | --     | 16,699    | 18,246     |  |
| Consumer:                      |          |          |          |        |           |            |  |
| Home equity                    |          |          |          |        |           |            |  |
| 676                            | --       | 676      | 55       | 114    | 33,894    | 34,739     |  |
| Automobile                     |          |          |          |        |           |            |  |
| --                             | --       | --       | --       | --     | 665       | 665        |  |
| Other consumer                 |          |          |          |        |           |            |  |
| 2                              | --       | 2        | 6        | 8      | 3,620     | 3,636      |  |
| Total consumer                 |          |          |          |        |           |            |  |
| 678                            | --       | 678      | 61       | 122    | 38,179    | 39,040     |  |
| Commercial business            |          |          |          |        |           |            |  |
| 422                            | --       | 422      | --       | --     | 5,796     | 6,218      |  |
| Leases                         |          |          |          |        |           |            |  |
| --                             | --       | --       | --       | --     | 257       | 257        |  |
| Total noncovered loans         |          |          |          |        |           |            |  |
| 15,694                         | --       | 15,694   | 1,496    | 271    | 307,902   | 325,363    |  |
| Covered loans                  |          |          |          |        |           |            |  |
| Real estate:                   |          |          |          |        |           |            |  |
| One-to-four family residential |          |          |          |        |           |            |  |
| 753                            | --       | 753      | --       | --     | 11,416    | 12,169     |  |
| Multifamily residential        |          |          |          |        |           |            |  |
| 1,372                          | --       | 1,372    | --       | --     | 6,480     | 7,852      |  |
| Commercial real estate         |          |          |          |        |           |            |  |
| 5,934                          | --       | 5,934    | --       | --     | 55,200    | 61,134     |  |
| Total real estate              |          |          |          |        |           |            |  |
| 8,059                          | --       | 8,059    | --       | --     | 73,096    | 81,155     |  |
| Real estate construction:      |          |          |          |        |           |            |  |
| One-to-four family residential |          |          |          |        |           |            |  |
| 666                            | --       | 666      | --       | --     | 353       | 1,019      |  |
| Commercial real estate         |          |          |          |        |           |            |  |
| 1,341                          | --       | 1,341    | 311      | --     | 5,366     | 7,018      |  |
| 2,007                          | --       | 2,007    | 311      | --     | 5,719     | 8,037      |  |

Total real estate  
construction

Consumer:

|                     |           |       |           |          |        |            |            |
|---------------------|-----------|-------|-----------|----------|--------|------------|------------|
| Home equity         | 209       | --    | 209       | --       | --     | 12,405     | 12,614     |
| Automobile          | --        | --    | --        | --       | --     | 281        | 281        |
| Other consumer      | 5         | --    | 5         | --       | --     | 973        | 978        |
| Total consumer      | 214       | --    | 214       | --       | --     | 13,659     | 13,873     |
| Commercial business | 160       | --    | 160       | --       | --     | 34,844     | 35,004     |
| Leases              | --        | --    | --        | --       | --     | 1,902      | 1,902      |
| Total covered loans | 10,440    | --    | 10,440    | 311      | --     | 129,220    | 139,971    |
| Total gross loans   | \$ 26,134 | \$ -- | \$ 26,134 | \$ 1,807 | \$ 271 | \$ 437,122 | \$ 465,334 |



**Loan Classification.** The Company categorizes loans into risk categories based on relevant information about the ability of borrowers to service their debt such as current financial information, historical payment experience, credit documentation, public information, and current economic trends, among other factors. The Company analyzes loans individually by classifying the loans as to credit risk. This analysis is performed on a monthly basis. The Company uses the following definitions for risk classification ratings:

**Watch:** Loans that possess some reason for additional management oversight, such as correctable documentation deficiencies, recent financial setbacks, deteriorating financial position, industry concerns, and failure to perform on other borrowing obligations. Loans with this classification are to be monitored in an effort to correct deficiencies and upgrade the credit if warranted. At the time of this classification, they are not believed to expose the Company to significant risk.

**Special Mention:** Performing loans that have developed minor credit weaknesses since origination. Evidence of credit weakness include the primary source of repayment has deteriorated and no longer meets debt service requirements as defined in Company policy, the borrower may have a short track record and little depth of management, inadequate current financial information, marginal capitalization, and susceptibility to negative industry trends. The primary source of repayment remains viable but there is increasing reliance on collateral or guarantor support.

**Substandard:** A loan is considered substandard if it is inadequately protected by the current net worth, liquidity and paying capacity of the borrower or collateral pledged. Substandard assets include those characterized by the distinct possibility that the Company will sustain some loss if the deficiencies are not corrected.

**Doubtful:** Loans classified as doubtful have all the weaknesses inherent in those classified substandard with the added characteristic that the weaknesses present make collection or liquidation in full highly questionable and improbable on the basis of currently existing facts, conditions and values.

**Loss:** This classification of loans includes loans that are considered uncollectible and of such little value that their continuance as an active asset is not warranted. This does not mean the loan has no salvage value, but is neither desirable nor practical to defer writing off this asset at this time. Once a determination has been made that a loss exists, the loss amount will be charged-off. As a result, generally, the Company will not report loan balances as "Loss."

**Pass:** Loans not meeting the criteria above are considered to be pass rated loans. The pass classification also includes homogenous loans (such as one-to-four family residential and consumer loans) unless the borrower experiences a delinquency or requests a modification, at which point the loan is graded as specified above.

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As of September 30, 2012 and December 31, 2011, and based on the most recent analysis performed, the risk category of loans by portfolio class is as follows (in thousands):

|                                  | Pass     | Watch  | September 30, 2012<br>Special<br>Mention | Substandard | Doubtful | Total<br>Loans |
|----------------------------------|----------|--------|--|-------------|----------|----------------|
| <b>Noncovered loans</b>          |          |        |  |             |          |                |
| <b>Real estate:</b>              |          |        |  |             |          |                |
| One-to-four family residential   | \$79,856 | \$488  | \$--                                     | \$4,730     | \$--     | \$85,074       |
| Multifamily residential          | 30,681   | --     | 39                                       | 956         | --       | 31,676         |
| Commercial real estate           | 90,040   | 5,780  | 13,093                                   | 24,563      | --       | 133,476        |
| Total real estate                | 200,577  | 6,268  | 13,132                                   | 30,249      | --       | 250,226        |
| <b>Real estate construction:</b> |          |        |  |             |          |                |
| One-to-four family residential   | 12,955   | --     | --                                       | 672         | --       | 13,627         |
| Multifamily residential          | 98       | --     | --                                       | --          | --       | 98             |
| Commercial real estate           | 19,170   | --     | --                                       | 253         | --       | 19,423         |
| Total real estate construction   | 32,223   | --     | --                                       | 925         | --       | 33,148         |
| <b>Consumer:</b>                 |          |        |  |             |          |                |
| Home equity                      | 31,755   | 117    | --                                       | 693         | --       | 32,565         |
| Automobile                       | 707      | 2      | --                                       | --          | --       | 709            |
| Other consumer                   | 2,779    | 37     | 26                                       | 190         | --       | 3,032          |
| Total consumer                   | 35,241   | 156    | 26                                       | 883         | --       | 36,306         |
| Commercial business              | 13,508   | 734    | 165                                      | 535         | --       | 14,942         |
| Leases                           | 175      | --     | --                                       | --          | --       | 175            |
| Total noncovered loans           | 281,724  | 7,158  | 13,323                                   | 32,592      | --       | 334,797        |
| <b>Covered loans</b>             |          |        |  |             |          |                |
| <b>Real estate:</b>              |          |        |  |             |          |                |
| One-to-four family residential   | 3,651    | --     | 1,350                                    | 5,073       | --       | 10,074         |
| Multifamily residential          | 2,886    | 380    | 109                                      | 397         | --       | 3,772          |
| Commercial real estate           | 21,490   | 12,077 | 1,832                                    | 15,588      | --       | 50,987         |
| Total real estate                | 28,027   | 12,457 | 3,291                                    | 21,058      | --       | 64,833         |
| <b>Real estate construction:</b> |          |        |  |             |          |                |
| Commercial real estate           | 862      | 4,203  | 782                                      | 645         | --       | 6,492          |
| Total real estate construction   | 862      | 4,203  | 782                                      | 645         | --       | 6,492          |
| <b>Consumer:</b>                 |          |        |  |             |          |                |
| Home equity                      | 10,636   | 77     | --                                       | 91          | --       | 10,804         |
| Automobile                       | 227      | 4      | --                                       | --          | --       | 231            |
| Other consumer                   | 763      | 17     | --                                       | 15          | --       | 795            |
| Total consumer                   | 11,626   | 98     | --                                       | 106         | --       | 11,830         |
| Commercial business              | 10,993   | 708    | 640                                      | 3,115       | --       | 15,456         |
| Leases                           | 596      | --     | --                                       | --          | --       | 596            |

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|                     |           |          |          |          |      |           |
|---------------------|-----------|----------|----------|----------|------|-----------|
| Total covered loans | 52,104    | 17,466   | 4,713    | 24,924   | --   | 99,207    |
| Total gross loans   | \$333,828 | \$24,624 | \$18,036 | \$57,516 | \$-- | \$434,004 |

|                                | December 31, 2011 |        |                    |             |          | Total     |
|--------------------------------|-------------------|--------|--------------------|-------------|----------|-----------|
|                                | Pass              | Watch  | Special<br>Mention | Substandard | Doubtful | Loans     |
| <b>Noncovered loans</b>        |                   |        |                    |             |          |           |
| Real estate:                   |                   |        |                    |             |          |           |
| One-to-four family residential | \$97,444          | \$110  | \$--               | \$5,783     | \$--     | \$103,337 |
| Multifamily residential        | 8,131             | 1,670  | 1,024              | 2,359       | --       | 13,184    |
| Commercial real estate         | 90,458            | 4,307  | 19,407             | 30,909      | --       | 145,081   |
| Total real estate              | 196,033           | 6,087  | 20,431             | 39,051      | --       | 261,602   |
| Real estate construction:      |                   |        |                    |             |          |           |
| One-to-four family residential | 3,849             | 3,819  | --                 | 668         | --       | 8,336     |
| Commercial real estate         | 8,018             | --     | 512                | 1,380       | --       | 9,910     |
| Total real estate construction | 11,867            | 3,819  | 512                | 2,048       | --       | 18,246    |
| Consumer:                      |                   |        |                    |             |          |           |
| Home equity                    | 33,715            | 127    | 40                 | 857         | --       | 34,739    |
| Automobile                     | 660               | 5      | --                 | --          | --       | 665       |
| Other consumer                 | 3,248             | 64     | 41                 | 283         | --       | 3,636     |
| Total consumer                 | 37,623            | 196    | 81                 | 1,140       | --       | 39,040    |
| Commercial business            | 5,163             | 304    | 329                | 422         | --       | 6,218     |
| Leases                         | 257               | --     | --                 | --          | --       | 257       |
| Total noncovered loans         | 250,943           | 10,406 | 21,353             | 42,661      | --       | 325,363   |
| <b>Covered loans</b>           |                   |        |                    |             |          |           |
| Real estate:                   |                   |        |                    |             |          |           |
| One-to-four family residential | 4,196             | 347    | 1,573              | 6,053       | --       | 12,169    |
| Multifamily residential        | 5,118             | 976    | 169                | 1,589       | --       | 7,852     |
| Commercial real estate         | 24,134            | 1,672  | 11,812             | 23,516      | --       | 61,134    |
| Total real estate              | 33,448            | 2,995  | 13,554             | 31,158      | --       | 81,155    |
| Real estate construction:      |                   |        |                    |             |          |           |
| One-to-four family residential | 230               | --     | --                 | 789         | --       | 1,019     |
| Commercial real estate         | 1,760             | 102    | 2,705              | 2,451       | --       | 7,018     |
| Total real estate construction | 1,990             | 102    | 2,705              | 3,240       | --       | 8,037     |
| Consumer:                      |                   |        |                    |             |          |           |
| Home equity                    | 11,713            | 138    | --                 | 763         | --       | 12,614    |
| Automobile                     | 281               | --     | --                 | --          | --       | 281       |
| Other consumer                 | 942               | 14     | --                 | 22          | --       | 978       |
| Total consumer                 | 12,936            | 152    | --                 | 785         | --       | 13,873    |
| Commercial business            | 21,408            | 1,755  | 5,353              | 6,488       | --       | 35,004    |
| Leases                         | 1,902             | --     | --                 | --          | --       | 1,902     |

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|                     |           |          |          |           |      |           |
|---------------------|-----------|----------|----------|-----------|------|-----------|
| Total covered loans | 71,684    | 5,004    | 21,612   | 41,671    | --   | 139,971   |
| Total gross loans   | \$322,627 | \$15,410 | \$42,965 | \$ 84,332 | \$-- | \$465,334 |

Impaired Loans. A loan is considered impaired when, based upon currently known information, it is deemed probable that the Company will be unable to collect all amounts due as scheduled according to the original terms of the agreement with the borrower. Additionally, all troubled debt restructurings ("TDRs") are considered impaired.

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The following tables present loans deemed impaired by portfolio class as of September 30, 2012 and December 31, 2011, and during the three and nine months ended September 30, 2012 and 2011 (in thousands):

|   | September 30, 2012       |                     |                                     | Average Recorded Investment      |                                 |
|---|--------------------------|---------------------|-------------------------------------|----------------------------------|---------------------------------|
|   | Unpaid Principal Balance | Recorded Investment | Allowance for Loan Losses Allocated | Three Months Ended Sep. 30, 2012 | Nine Months Ended Sep. 30, 2012 |
| Noncovered loans                                  |                          |                     |                                     |                                  |                                 |
| With no related allowance recorded:               |                          |                     |                                     |                                  |                                 |
| Real estate:                                      |                          |                     |                                     |                                  |                                 |
| One-to-four family residential                    | \$4,513                  | \$3,712             | \$--                                | \$3,389                          | \$3,998                         |
| Commercial real estate                            | 5,024                    | 4,938               | --                                  | 4,881                            | 4,273                           |
| Total real estate                                 | 9,537                    | 8,650               | --                                  | 8,270                            | 8,271                           |
| Real estate construction:                         |                          |                     |                                     |                                  |                                 |
| One-to-four family residential                    | 328                      | 271                 | --                                  | 277                              | 341                             |
| Commercial real estate                            | 155                      | 155                 | --                                  | 229                              | 114                             |
| Total real estate construction                    | 483                      | 426                 | --                                  | 506                              | 455                             |
| Consumer:   |                          |                     |                                     |                                  |                                 |
| Home equity                                       | 789                      | 425                 | --                                  | 437                              | 631                             |
| Automobile  | --                       | --                  | --                                  | --                               | 23                              |
| Other consumer                                    | --                       | --                  | --                                  | --                               | 8                               |
| Total consumer                                    | 789                      | 425                 | --                                  | 437                              | 662                             |
| Commercial business                               | 370                      | 370                 | --                                  | 362                              | 383                             |
| Total noncovered loans with no related allowance  | 11,179                   | 9,871               | --                                  | 9,575                            | 9,771                           |
| With an allowance recorded:                       |                          |                     |                                     |                                  |                                 |
| Real estate:                                      |                          |                     |                                     |                                  |                                 |
| One-to-four family residential                    | 1,234                    | 1,234               | (325 )                              | 1,365                            | 1,477                           |
| Multifamily residential                           | 839                      | 839                 | (114 )                              | 847                              | 423                             |
| Commercial real estate                            | 4,420                    | 4,420               | (338 )                              | 4,607                            | 5,368                           |
| Total real estate                                 | 6,493                    | 6,493               | (777 )                              | 6,819                            | 7,268                           |
| Real estate construction:                         |                          |                     |                                     |                                  |                                 |
| One-to-four family residential                    | 401                      | 401                 | (138 )                              | 376                              | 387                             |
| Commercial real estate                            | 98                       | 98                  | (33 )                               | 203                              | 302                             |
| Total real estate construction                    | 499                      | 499                 | (171 )                              | 579                              | 689                             |
| Home equity                                       | 283                      | 283                 | (253 )                              | 288                              | 294                             |
| Commercial business                               | --                       | --                  | --                                  | --                               | --                              |
| Total noncovered loans with an allowance recorded | 7,275                    | 7,275               | (1,201 )                            | 7,686                            | 8,251                           |

|   |          |          |            |          |          |
|---|----------|----------|------------|----------|----------|
| Covered loans                                 |          |          |            |          |          |
| With no related allowance recorded:           |          |          |            |          |          |
| Real estate:                                  |          |          |            |          |          |
| One-to-four family residential                | 62       | 63       | --         | 32       | 215      |
| Commercial real estate                        | 3,085    | 2,614    | --         | 2,560    | 2,641    |
| Total real estate                             | 3,147    | 2,677    | --         | 2,592    | 2,856    |
| Commercial real estate construction           | 513      | 254      | --         | 263      | 481      |
| Home equity                                   | 683      | 89       | --         | 100      | 157      |
| Commercial business and leases                | --       | --       | --         | 8        | 425      |
| Total covered loans with no related allowance | 4,343    | 3,020    | --         | 2,963    | 3,919    |
| Total impaired loans                          | \$22,797 | \$20,166 | \$(1,201 ) | \$20,224 | \$21,941 |

At September 30, 2012, the unpaid principal balance for purposes of this table includes \$2.6 million that was partially charged-off but not forgiven.

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|   | December 31, 2011        |                     |                                     | Average Recorded Investment      |                                 |
|---|--------------------------|---------------------|-------------------------------------|----------------------------------|---------------------------------|
|   | Unpaid Principal Balance | Recorded Investment | Allowance for Loan Losses Allocated | Three Months Ended Sep. 30, 2011 | Nine Months Ended Sep. 30, 2011 |
| <b>Noncovered loans</b>                           |                          |                     |                                     |                                  |                                 |
| With no related allowance recorded:               |                          |                     |                                     |                                  |                                 |
| Real estate:                                      |                          |                     |                                     |                                  |                                 |
| One-to-four family residential                    | \$5,147                  | \$4,654             | \$--                                | \$2,823                          | \$1,834                         |
| Commercial real estate                            | 2,651                    | 2,415               | --                                  | 1,875                            | 2,194                           |
| Total real estate                                 | 7,798                    | 7,069               | --                                  | 4,698                            | 4,028                           |
| Real estate construction:                         |                          |                     |                                     |                                  |                                 |
| One-to-four family residential                    | 196                      | 139                 | --                                  | --                               | --                              |
| Commercial real estate                            | 1,959                    | 631                 | --                                  | 1,722                            | 1,205                           |
| Total real estate construction                    | 2,155                    | 770                 | --                                  | 1,722                            | 1,205                           |
| Consumer:   |                          |                     |                                     |                                  |                                 |
| Home equity                                       | 1,010                    | 614                 | --                                  | 244                              | 147                             |
| Automobile  | 25                       | 25                  | --                                  | --                               | 2                               |
| Other consumer                                    | 17                       | 17                  | --                                  | --                               | --                              |
| Total consumer                                    | 1,052                    | 656                 | --                                  | 244                              | 150                             |
| Commercial business                               | 592                      | 427                 | --                                  | 535                              | 390                             |
| Total noncovered loans with no related allowance  | 11,597                   | 8,922               | --                                  | 7,198                            | 5,773                           |
| With an allowance recorded:                       |                          |                     |                                     |                                  |                                 |
| Real estate:                                      |                          |                     |                                     |                                  |                                 |
| One-to-four family residential                    | 1,572                    | 1,576               | (359 )                              | 1,897                            | 2,062                           |
| Commercial real estate                            | 6,035                    | 6,035               | (737 )                              | 4,212                            | 5,227                           |
| Total real estate                                 | 7,607                    | 7,611               | (1,096 )                            | 6,108                            | 7,288                           |
| Real estate construction:                         |                          |                     |                                     |                                  |                                 |
| One-to-four family residential                    | 367                      | 367                 | (105 )                              | 278                              | 660                             |
| Commercial real estate                            | 506                      | 506                 | (99 )                               | 239                              | 839                             |
| Total real estate construction                    | 873                      | 873                 | (204 )                              | 517                              | 1,499                           |
| Home equity                                       | 303                      | 303                 | (269 )                              | 139                              | 134                             |
| Commercial business                               | --                       | --                  | --                                  | --                               | 479                             |
| Total noncovered loans with an allowance recorded | 8,783                    | 8,787               | (1,569 )                            | 6,763                            | 9,401                           |
| <b>Covered loans</b>                              |                          |                     |                                     |                                  |                                 |
| With no related allowance recorded:               |                          |                     |                                     |                                  |                                 |
| Real estate:                                      |                          |                     |                                     |                                  |                                 |
| One-to-four family residential                    | 663                      | 436                 | --                                  | 493                              | 342                             |
| Commercial real estate                            | 3,279                    | 2,708               | --                                  | 4,893                            | 5,970                           |



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|   |          |          |            |          |          |
|---|----------|----------|------------|----------|----------|
| Total real estate                             | 3,942    | 3,144    | --         | 5,386    | 6,312    |
| Commercial real estate construction           | 1,798    | 864      | --         | 1,613    | 1,637    |
| Consumer:                                     |          |          |            |          |          |
| Home equity                                   | 643      | 209      | --         | 38       | 19       |
| Consumer                                      | 4        | 4        | --         | 10       | 5        |
| Total consumer                                | 647      | 213      | --         | 48       | 24       |
| Commercial business and leases                | 236      | 212      | --         | 250      | 350      |
| Total covered loans with no related allowance | 6,623    | 4,433    | --         | 7,296    | 8,322    |
| Total impaired loans                          | \$27,003 | \$22,142 | \$(1,569 ) | \$21,257 | \$23,496 |

At December 31, 2011, the unpaid principal balance for purposes of this table includes \$5.2 million that has been partially charged-off but not forgiven. Interest income recorded on impaired loans was immaterial during the three and nine months ended September 30, 2012 and 2011.

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Allowance for Loan Losses. The following table presents the balance in the allowance for loan losses and the recorded investment in loans by portfolio segment and based on impairment method as of September 30, 2012 and December 31, 2011 (in thousands):

|                         | September 30, 2012                             |  |   | Recorded Investment                            |  |   |
|-------------------------|--|--|---|--|--|---|
|                         | Allowance for Loan Losses                      |  |   |  |  |   |
|                         | Individually<br>Evaluated<br>for<br>Impairment | Collectively<br>Evaluated<br>for<br>Impairment | Acquired<br>with<br>Deteriorated<br>Credit<br>Quality | Individually<br>Evaluated<br>for<br>Impairment | Collectively<br>Evaluated<br>for<br>Impairment | Acquired<br>with<br>Deteriorated<br>Credit<br>Quality |
| <b>Noncovered loans</b> |  |  |   |  |  |   |
| Real estate             | \$ 777   | \$ 4,241                                       | \$ --   | \$ 15,143                                      | \$ 235,083                                     | \$ --   |
| Construction            | 171  | 797  | --  | 925  | 32,223   | --  |
| Consumer                | 253  | 1,702  | --  | 708  | 33,962   | 1,636   |
| Commercial business     | --   | 673  | --  | 370  | 14,747   | --  |
| Total noncovered        | 1,201  | 7,413  | --  | 17,146   | 316,015  | 1,636   |
| <b>Covered loans</b>    |  |  |   |  |  |   |
| Real estate             | --   | 679  | 1,339   | 2,677  | 22,939   | 39,217  |
| Construction            | --   | 154  | 239   | 254  | 1,880  | 4,358   |
| Consumer                | --   | 195  | 399   | 89   | 5,369  | 6,372   |
| Commercial business     | --   | 297  | 672   | --   | 4,180  | 11,872  |
| Total covered           | --   | 1,325  | 2,649   | 3,020  | 34,368   | 61,819  |
| <b>Total</b>            | <b>\$ 1,201</b>                                | <b>\$ 8,738</b>                                | <b>\$ 2,649</b>                                       | <b>\$ 20,166</b>                               | <b>\$ 350,383</b>                              | <b>\$ 63,455</b>                                      |

|                         | December 31, 2011                              |  |   | Recorded Investment                            |  |   |
|-------------------------|--|--|---|--|--|---|
|                         | Allowance for Loan Losses                      |  |   |  |  |   |
|                         | Individually<br>Evaluated<br>for<br>Impairment | Collectively<br>Evaluated<br>for<br>Impairment | Acquired<br>with<br>Deteriorated<br>Credit<br>Quality | Individually<br>Evaluated<br>for<br>Impairment | Collectively<br>Evaluated<br>for<br>Impairment | Acquired<br>with<br>Deteriorated<br>Credit<br>Quality |
| <b>Noncovered loans</b> |  |  |   |  |  |   |
| Real estate             | \$ 1,096                                       | \$ 5,827                                       | \$ --   | \$ 14,680                                      | \$ 246,922                                     | \$ --   |
| Construction            | 204  | 518  | --  | 1,643  | 16,603   | --  |
| Consumer                | 269  | 1,828  | --  | 959  | 35,867   | 2,214   |
| Commercial business     | --   | 205  | --  | 427  | 6,048  | --  |
| Total noncovered        | 1,569  | 8,378  | --  | 17,709   | 305,440  | 2,214   |
| <b>Covered loans</b>    |  |  |   |  |  |   |
| Real estate             | --   | 1,056  | --  | 3,144  | 27,995   | 50,016  |
| Construction            | --   | 151  | 2,050   | 864  | 1,547  | 5,626   |
| Consumer                | --   | 309  | 10  | 213  | 6,463  | 7,197   |
| Commercial business     | --   | 384  | 264   | 212  | 7,417  | 29,277  |
| Total covered           | --   | 1,900  | 2,324   | 4,433  | 43,422   | 92,116  |

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|       |          |           |          |           |            |           |
|-------|----------|-----------|----------|-----------|------------|-----------|
| Total | \$ 1,569 | \$ 10,278 | \$ 2,324 | \$ 22,142 | \$ 348,862 | \$ 94,330 |
|-------|----------|-----------|----------|-----------|------------|-----------|

Activity in the allowance for loan losses by portfolio segment for the three months ended September 30, 2012 and 2011 was as follows (in thousands):

|                         | As of June<br>30,<br>2012 | Provisions | Charge-Offs | Recoveries | As of<br>September<br>30,<br>2012 |
|-------------------------|---------------------------|------------|-------------|------------|-----------------------------------|
| <b>Noncovered loans</b> |                           |            |             |            |                                   |
| Real estate             | \$5,311                   | \$(165 )   | \$(166 )    | \$38       | \$5,018                           |
| Construction            | 840                       | 126        | --          | 2          | 968                               |
| Consumer                | 2,047                     | 74         | (190 )      | 24         | 1,955                             |
| Commercial business     | 707                       | (35 )      | (2 )        | 3          | 673                               |
| Total noncovered loans  | 8,905                     | --         | (358 )      | 67         | 8,614                             |
| <b>Covered loans</b>    |                           |            |             |            |                                   |
| Real estate             | 871                       | 744        | --          | 403        | 2,018                             |
| Construction            | 1,721                     | (1,439 )   | (12 )       | 123        | 393                               |
| Consumer                | 665                       | 188        | (259 )      | --         | 594                               |
| Commercial business     | 458                       | 612        | (132 )      | 31         | 969                               |
| Total covered loans     | 3,715                     | 105        | (403 )      | 557        | 3,974                             |
| Total                   | \$12,620                  | \$105      | \$(761 )    | \$624      | \$12,588                          |
| <br>                    |                           |            |             |            |                                   |
|                         | As of June<br>30,<br>2011 | Provisions | Charge-Offs | Recoveries | As of<br>September<br>30,<br>2011 |
| <b>Noncovered loans</b> |                           |            |             |            |                                   |
| Real estate             | \$6,925                   | \$(380 )   | \$(165 )    | \$19       | \$6,399                           |
| Construction            | 883                       | 9          | --          | 6          | 898                               |
| Consumer                | 1,333                     | 364        | (112 )      | 56         | 1,641                             |
| Commercial business     | 317                       | 29         | (59 )       | --         | 287                               |
| Total noncovered loans  | 9,458                     | 22         | (336 )      | 81         | 9,225                             |
| <b>Covered loans</b>    |                           |            |             |            |                                   |
| Real estate             | 2,188                     | 123        | (726 )      | 89         | 1,674                             |
| Construction            | 628                       | 2,371      | (686 )      | 256        | 2,569                             |
| Consumer                | 316                       | 151        | (108 )      | 12         | 371                               |
| Commercial business     | 797                       | (82 )      | (541 )      | 352        | 526                               |
| Total covered loans     | 3,929                     | 2,563      | (2,061 )    | 709        | 5,140                             |
| Total                   | \$13,387                  | \$2,585    | \$(2,397 )  | \$790      | \$14,365                          |

Activity in the allowance for loan losses by portfolio segment for the nine months ended September 30, 2012 and 2011 was as follows (in thousands):

|                         | As of<br>December<br>31,<br>2011 | Provisions | Charge-Offs | Recoveries | As of<br>September<br>30,<br>2012 |
|-------------------------|----------------------------------|------------|-------------|------------|-----------------------------------|
| <b>Noncovered loans</b> |                                  |            |             |            |                                   |
| Real estate             | \$6,923                          | \$(1,045 ) | \$(912 )    | \$52       | \$5,018                           |
| Construction            | 722                              | 200        | --          | 46         | 968                               |
| Consumer                | 2,097                            | 307        | (506 )      | 57         | 1,955                             |
| Commercial business     | 205                              | 538        | (73 )       | 3          | 673                               |
| Total noncovered loans  | 9,947                            | --         | (1,491 )    | 158        | 8,614                             |
| <b>Covered loans</b>    |                                  |            |             |            |                                   |
| Real estate             | 1,056                            | (361 )     | (320 )      | 1,643      | 2,018                             |
| Construction            | 2,201                            | (2,247 )   | (290 )      | 729        | 393                               |
| Consumer                | 319                              | 767        | (492 )      | --         | 594                               |
| Commercial business     | 648                              | 729        | (489 )      | 81         | 969                               |
| Total covered loans     | 4,224                            | (1,112 )   | (1,591 )    | 2,453      | 3,974                             |
| Total                   | \$14,171                         | \$(1,112 ) | \$(3,082 )  | \$2,611    | \$12,588                          |
|                         |                                  |            |             |            |                                   |
|                         | As of<br>December<br>31,<br>2010 | Provisions | Charge-Offs | Recoveries | As of<br>September<br>30,<br>2011 |
| <b>Noncovered loans</b> |                                  |            |             |            |                                   |
| Real estate             | \$8,746                          | \$(785 )   | \$(1,785 )  | \$223      | \$6,399                           |
| Construction            | 957                              | 335        | (599 )      | 205        | 898                               |
| Consumer                | 1,410                            | 1,138      | (1,025 )    | 118        | 1,641                             |
| Commercial business     | 851                              | (466 )     | (236 )      | 138        | 287                               |
| Total noncovered loans  | 11,964                           | 222        | (3,645 )    | 684        | 9,225                             |
| <b>Covered loans</b>    |                                  |            |             |            |                                   |
| Real estate             | 2,080                            | 2,286      | (2,841 )    | 149        | 1,674                             |
| Construction            | 453                              | 5,236      | (3,909 )    | 789        | 2,569                             |
| Consumer                | 470                              | 251        | (374 )      | 24         | 371                               |
| Commercial business     | 442                              | 401        | (677 )      | 360        | 526                               |
| Total covered loans     | 3,445                            | 8,174      | (7,801 )    | 1,322      | 5,140                             |
| Total                   | \$15,409                         | \$8,396    | \$(11,446 ) | \$2,006    | \$14,365                          |

TDRs. The internal process used to assess whether a modification should be reported and accounted for as a TDR includes an assessment of the borrower's payment history, considering whether the borrower is in financial difficulty, whether a concession has been granted, and whether it is likely the borrower will be able to perform under the modified terms. The modification of the terms of such loans generally includes one or a combination of the following: a reduction of the stated interest rate of the loan; an extension of the maturity date at a stated rate of interest lower than the current market rate for the new debt with similar risk; or a permanent reduction of the recorded investment in the

loan.

TDRs totaled \$11.9 million and \$9.1 million at September 30, 2012 and December 31, 2011, respectively, and are included in the impaired loan disclosures below. Of these amounts, \$353,000 and \$620,000 were covered under loss sharing agreements with the FDIC at September 30, 2012 and December 31, 2011, respectively. The Company has allocated \$904,000 of specific reserves to customers whose loan terms have been modified in TDRs at September 30, 2012, compared to \$1.1 million at December 31, 2011. There were no commitments to lend additional amounts to customers with outstanding loans that are classified as TDRs.

Modifications to loans not accounted for as TDRs totaled \$1.1 million at September 30, 2012, of which \$418,000 was in the noncovered loan portfolio. These loans were not considered to be TDRs because the borrower was not under financial difficulty at the time of the modification or extension. Extensions are made at market rates as evidenced by comparison to newly originated loans of generally comparable credit quality and structure.

The following table presents TDRs at September 30, 2012 and December 31, 2011 (in thousands):

|                                | September 30, 2012 |                      |                        | December 31, 2011 |                      |                        |
|--------------------------------|--------------------|----------------------|------------------------|-------------------|----------------------|------------------------|
|                                | Accrual<br>Status  | Nonaccrual<br>Status | Total<br>Modifications | Accrual<br>Status | Nonaccrual<br>Status | Total<br>Modifications |
| <b>Noncovered loans</b>        |                    |                      |                        |                   |                      |                        |
| One-to-four family residential | \$ 1,449           | \$ 745               | \$ 2,194               | \$ 241            | \$ 1,549             | \$ 1,790               |
| Commercial real estate         | 1,498              | 5,714                | 7,212                  | 274               | 5,309                | 5,583                  |
| Multifamily residential        | --                 | 839                  | 839                    | --                | --                   | --                     |
| Real estate construction       | 59                 | 733                  | 792                    | 6                 | 428                  | 434                    |
| Home equity                    | 16                 | 162                  | 178                    | 16                | 234                  | 250                    |
| Commercial business            | --                 | 329                  | 329                    | --                | 395                  | 395                    |
| Total noncovered               | 3,022              | 8,522                | 11,544                 | 537               | 7,915                | 8,452                  |
| <b>Covered loans</b>           |                    |                      |                        |                   |                      |                        |
| Commercial real estate         | 176                | 177                  | 353                    | 180               | 232                  | 412                    |
| Real estate construction       | --                 | --                   | --                     | --                | 208                  | 208                    |
| Total covered                  | 176                | 177                  | 353                    | 180               | 440                  | 620                    |
| Total                          | \$3,198            | \$8,699              | \$ 11,897              | \$717             | \$8,355              | \$ 9,072               |

During the three months ended March 31, 2012, there was one new TDR. The modification involved an extension of the loan term by twelve months and did not result in any charge-off or impairment. During the three months ended June 30, 2012, there were 13 new TDRs, nine of which involve one customer relationship. For those nine loans, which include \$897,000 of commercial and multifamily loans and \$384,000 of construction loans, the modifications involved extensions of the maturity dates by two years. There were no new TDRs during the three months ended September 30, 2012.

The following table presents new TDRs during the three and nine months ended September 30, 2012 (dollars in thousands).

|                         | Three Months Ended September 30, 2012 |                                 |                                  | Nine Months Ended September 30, 2012 |                                 |                                  |
|-------------------------|---------------------------------------|---------------------------------|----------------------------------|--------------------------------------|---------------------------------|----------------------------------|
|                         | Number<br>of<br>Contracts             | Pre-<br>Modification<br>Balance | Post-<br>Modification<br>Balance | Number of<br>Contracts               | Pre-<br>Modification<br>Balance | Post-<br>Modification<br>Balance |
| <b>Noncovered loans</b> |                                       |                                 |                                  |                                      |                                 |                                  |
|                         | --                                    | \$ --                           | \$ --                            | 3                                    | \$ 861                          | \$ 876                           |

One-to-four family  
residential

|                          |    |       |       |    |          |          |
|--------------------------|----|-------|-------|----|----------|----------|
| Commercial real estate   | -- | --    | --    | 3  | 4,322    | 4,322    |
| Real estate construction | -- | --    | --    | 8  | 828      | 778      |
| Total                    | -- | \$ -- | \$ -- | 14 | \$ 6,011 | \$ 5,976 |

During the three months ended September 30, 2012, we did not recognize any charge-offs on TDRs, while three TDRs totaling \$270,000 were paid off.



The following table presents TDRs at September 30, 2012 and December 31, 2011 which were performing according to agreement (dollars in thousands):

|                                  | September 30, 2012     |                        | December 31, 2011      |                        |
|----------------------------------|------------------------|------------------------|------------------------|------------------------|
|                                  | Number of<br>Contracts | Recorded<br>Investment | Number of<br>Contracts | Recorded<br>Investment |
| <b>Noncovered loans</b>          |                        |                        |                        |                        |
| One- to four- family residential | 12                     | \$ 2,194               | 9                      | \$ 1,428               |
| Commercial real estate           | 4                      | 7,212                  | 3                      | 4,118                  |
| Multifamily residential          | 1                      | 839                    | --                     | --                     |
| Real estate construction         | 11                     | 792                    | 3                      | 344                    |
| Home equity                      | 3                      | 178                    | 3                      | 198                    |
| Commercial business              | 1                      | 329                    | --                     | --                     |
| Total noncovered                 | 32                     | 11,544                 | 18                     | 6,088                  |
| <b>Covered loans</b>             |                        |                        |                        |                        |
| Commercial real estate           | 2                      | 353                    | 2                      | 411                    |
| Total covered                    | 2                      | 353                    | 2                      | 411                    |
| Total                            | 34                     | \$ 11,897              | 20                     | \$ 6,499               |

**Purchased Credit Impaired Loans.** The Bank has purchased loans for which there was, at acquisition, evidence of deterioration of credit quality since origination and it was probable, at acquisition, that all contractually required payments would not be collected. These loans are accounted for under ASC 310-30. At the acquisition date, management estimated the fair value of the acquired loan portfolios which represented the expected cash flows from the portfolio discounted at a market-based rate. Included in the estimate of fair value was a discount credit adjustment that reflected expected credit losses. In estimating the preliminary fair value, management calculated the contractual amount and timing of undiscounted principal and interest payments (the “undiscounted contractual cash flows”) and estimated the amount and timing of undiscounted expected principal and interest payments (the “undiscounted expected cash flows”). The amount by which the undiscounted expected cash flows exceed the estimated fair value (the “accretable yield”) is accreted into interest income over the life of the loans. The difference between the undiscounted contractual cash flows and the undiscounted expected cash flows is the nonaccretable difference. The nonaccretable difference represents an estimate of the credit risk in the acquired loan and lease portfolio at the acquisition date. The following table details activity of accretable yield for the three and nine months ended September 30, 2012 and 2011 (in thousands):

|  | Three Months Ended<br>September 30,<br>2012 |           | Nine Months Ended<br>September 30,<br>2012 |           |
|--|---|-----------|--|-----------|
|  | 2012  | 2011      | 2012                                       | 2011      |
| Beginning balance of accretable yield          | \$23,084                                    | \$25,500  | \$28,915                                   | \$31,727  |
| <b>Changes in accretable yield due to:</b>     |   |           |  |           |
| Transfer from nonaccretable difference         | (191 )                                      | 16,505    | 4,541                                      | 16,505    |
| Accretable yield recognized as interest income | (5,510 )                                    | (10,145 ) | (16,073 )                                  | (16,372 ) |
| Ending balance of accretable yield             | \$17,383                                    | \$31,860  | \$17,383                                   | \$31,860  |

The carrying amount of loans for which income is not being recognized on loans individually accounted for under ASC 310-30 totaled \$4.2 million and \$7.7 million at September 30, 2012 and December 31, 2011, respectively, all of

which were purchased in the CFB Acquisition. At September 30, 2012 and December 31, 2011, the allowance for losses on purchased credit impaired loans was \$2.7 million and \$2.3 million, respectively. The provision for loan losses and reductions in the allowance for purchased credit impaired loans was \$486,000 and \$0, respectively, during the quarter ended September 30, 2012, and \$821,000 and \$493,000, respectively, during the nine months ended September 30, 2012.

#### Note 6 – Fair Value Measurement

Fair value is the exchange price that would be received for an asset or paid to transfer a liability (exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. There are three levels of inputs that may be used to measure fair values:

Level 1 – Unadjusted quoted prices for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

Level 2 – Significant other observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.

Level 3 – Significant unobservable inputs for determining the fair values of assets or liabilities that reflect an entity's own assumptions about the assumptions that market participants would use in pricing the assets or liabilities.

The Company used the following methods and significant assumptions to estimate fair value:

**Investments.** The fair values for investments are determined by quoted market prices, if available (Level 1). For investments where quoted prices are not available, fair values are calculated based on market prices of similar investments (Level 2).

**Impaired Loans.** The fair value of impaired loans is generally based on recent appraisals if the loan is collateral-based or on a cash flow analysis if repayment of the loan is generally dependent on the cash flow of the borrower. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Appraisals on loans secured by one-to-four family residential properties are updated when the loan becomes 120 days past due, or earlier if circumstances indicate the borrower will be unable to repay the loan under the terms of the note. Additionally, appraisals are updated if the borrower requests a modification to their loan. On commercial real estate and multifamily loans, appraisals are updated upon a determination that the borrower will be unable to repay the loan according to the terms of the note or upon a notice of default, whichever is earlier. Appraisals are updated on all loan types immediately prior to a foreclosure sale and at least annually thereafter once the collateral title has been transferred to the Bank. The frequency of appraisal updates is based upon property type and market trends, with nearly all currently being reappraised semi-annually. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually adjustments to the sales price of the comparable properties, as deemed appropriate by the appraiser, based on the age, condition, location or general characteristics of the subject property. If the income approach is used by an appraiser, a discount rate or a "capitalization rate" is applied to estimated net operating income for the income producing property. This capitalization rate is applied to estimate the fair value of the property. Capitalization rates vary based on the type of property (e.g., office, warehouse, retail) and local market dynamics (e.g., population, employment, absorption or saturation of specific property types), among other factors.

**Real Estate Owned (REO).** Nonrecurring adjustments to certain commercial and residential real estate properties classified as REO are measured at fair value, less costs to sell. Fair values are based on recent real estate appraisals. At least semi-annually, all REO is evaluated and the respective carrying balances are adjusted downward if warranted. Appraisals may use a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value. These valuation techniques and adjustments are described in greater detail above under "Impaired Loans." Management will typically

discount appraised values by 8.5%, which is based on historical experience to estimate selling costs, when determining the fair value of REO.

The following table summarizes the Company's financial assets that were measured at fair value on a recurring basis at September 30, 2012 and December 31, 2011, segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure fair value (in thousands):

|  | Level 1<br>Inputs | Level 2<br>Inputs | Level 3<br>Inputs | Total Fair<br>Value |
|--|-------------------|-------------------|-------------------|---------------------|
| <b>September 30, 2012</b>                        |                   |                   |                   |                     |
| Investments available-for-sale:                  |                   |                   |                   |                     |
| Obligations of U.S. GSE                          | \$--              | \$59,189          | \$--              | \$59,189            |
| U.S. Treasury bonds                              | 9,835             | --                | --                | 9,835               |
| Obligations of states and political subdivisions | --                | 42,620            | --                | 42,620              |
| Mortgage-backed securities, GSE issued           | --                | 332,498           | --                | 332,498             |
| Mortgage-backed securities, private label        | --                | 307               | --                | 307                 |
| <b>December 31, 2011</b>                         |                   |                   |                   |                     |
| Investments available-for-sale:                  |                   |                   |                   |                     |
| Obligations of U.S. GSE                          | \$--              | \$65,984          | \$--              | \$65,984            |
| Obligations of states and political subdivisions | --                | 21,809            | --                | 21,809              |
| Corporate note, FDIC-guaranteed                  | --                | 1,007             | --                | 1,007               |
| Mortgage-backed securities, GSE issued           | --                | 310,766           | --                | 310,766             |
| Mortgage-backed securities, private label        | --                | 311               | --                | 311                 |

Additionally, certain assets are measured at fair value on a non-recurring basis. These adjustments to fair value generally result from the application of lower-of-cost-or-market accounting or write-downs of individual assets due to impairment. The following table summarizes the Company's financial assets that were measured at fair value on a non-recurring basis at September 30, 2012 and December 31, 2011 (in thousands):

|  | Level 1<br>Inputs | Level 2<br>Inputs | Level 3<br>Inputs | Total Fair<br>Value |
|--|-------------------|-------------------|-------------------|---------------------|
| <b>September 30, 2012</b>                  |                   |                   |                   |                     |
| Impaired loans:                            |                   |                   |                   |                     |
| One-to-four family residential             | \$--              | \$--              | \$3,178           | \$3,178             |
| Commercial and multifamily                 | --                | --                | 7,215             | 7,215               |
| Real estate construction                   | --                | --                | 457               | 457                 |
| Home equity                                | --                | --                | 134               | 134                 |
| Total impaired loans                       | --                | --                | 10,984            | 10,984              |
| <b>REO:</b>                                |                   |                   |                   |                     |
| One-to-four family residential             | --                | --                | 506               | 506                 |
| Commercial and multifamily                 | --                | --                | 5,958             | 5,958               |
| Real estate construction                   | --                | --                | 2,078             | 2,078               |
| Total REO                                  | --                | --                | 8,542             | 8,542               |
| Total impaired loans and REO at fair value | \$--              | \$--              | \$19,526          | \$19,526            |

**December 31, 2011**

Impaired loans:

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|  |      |      |          |          |
|--|------|------|----------|----------|
| One-to-four family residential             | \$-- | \$-- | \$2,926  | \$2,926  |
| Commercial and multifamily                 | --   | --   | 7,684    | 7,684    |
| Real estate construction                   | --   | --   | 1,401    | 1,401    |
| Home equity                                | --   | --   | 297      | 297      |
| Commercial business                        | --   | --   | 25       | 25       |
| Total impaired loans                       | --   | --   | 12,333   | 12,333   |
| REO:                                       |      |      |          |          |
| One-to-four family residential             | --   | --   | 1,984    | 1,984    |
| Commercial and multifamily                 | --   | --   | 4,416    | 4,416    |
| Real estate construction                   | --   | --   | 4,551    | 4,551    |
| Total REO                                  | --   | --   | 10,951   | 10,951   |
| Total impaired loans and REO at fair value | \$-- | \$-- | \$23,284 | \$23,284 |

At September 30, 2012, impaired loans, which are measured for impairment using the fair value of the collateral, had a carrying amount of \$11.0 million, net of specific valuation allowances totaling \$1.2 million. At December 31, 2011, impaired loans at fair value had a carrying amount of \$12.3 million, net of specific allowances totaling \$1.6 million. Included in the value of impaired loans presented above at September 30, 2012 is \$4.9 million of loans that have been charged down to fair value. There was no net provision on noncovered loans during the quarter or nine month period ended September 30, 2012. During the quarter ended September 30, 2012, however, a provision for loan losses of \$105,000 was recorded, which was comprised of a negative provision of (\$382,000) related to recoveries on loans purchased in the CFB Acquisition, that was more than offset by a provision of \$487,000 on loan pools purchased in the LibertyBank Acquisition. A provision for loan losses on pooled loans is recorded when the estimated cash flows from the pool declines compared to previously estimated cash flows.

REO is recorded at estimated fair value less costs to sell had a carrying amount of \$8.5 million at September 30, 2012, which is comprised of the outstanding balance of \$8.5 million, with no valuation allowance. At December 31, 2011, REO measured at fair value less costs to sell had a carrying value of \$11.0 million, which is made up of the outstanding balance of \$11.0 million, with no valuation allowance. The provision for declines in the value of REO totaled \$56,000 and \$86,000 for the quarters ended September 30, 2012 and 2011, respectively, before offsetting amounts recoverable from the FDIC under loss sharing agreements. For the nine months ended September 30, 2012 and 2011, these provisions for REO totaled \$454,000 and \$739,000, respectively.

The following table presents information as of September 30, 2012 about significant unobservable inputs related to the Company's material categories of Level 3 financial assets measured on a nonrecurring basis (in thousands):

|  | Fair Value | Valuation<br>Technique          | Unobservable Inputs   | Range of<br>Inputs   | Weighted<br>Average |
|--|------------|---------------------------------|---|----------------------|---------------------|
| Impaired loans-<br>Commercial real estate<br>and multifamily | \$ 7,215   | Sales<br>comparison<br>approach | Adjustment for<br>differences between<br>the comparable sales | (15.7%) -<br>12.9 %  | (3.5 )%             |
|  |            | Income<br>approach              | Adjustment for<br>differences in<br>capitalization rates      | 9.00% -<br>10.00 %   | 9.3                 |
| Impaired loans-<br>Construction                              | 457        | Sales<br>comparison<br>approach | Adjustment for<br>differences between<br>the comparable sales | 1.9% - 12.7 %        | 7.0                 |
| REO- Commercial real<br>estate                               | 5,958      | Sales<br>comparison<br>approach | Adjustment for<br>differences between<br>the comparable sales | (15.9%) -<br>19.0 %  | (1.5 )              |
|  |            | Income<br>approach              | Adjustment for<br>differences in<br>capitalization rates      | 8.00% -<br>9.75 %    | 9.0                 |
| REO- Construction  | 2,078      | Sales<br>comparison<br>approach | Adjustment for<br>differences between<br>the comparable sales | (40.1%) -<br>(7.9) % | (27.4 )             |





The estimated fair values of the Company's financial instruments that are reported at amortized cost in the Company's Consolidated Balance Sheets, segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure fair value at September 30, 2012 and December 31, 2011 were as follows (in thousands):

|   | September 30, 2012 |                      | December 31, 2011 |                      |
|---|--------------------|----------------------|-------------------|----------------------|
|   | Carrying Value     | Estimated Fair Value | Carrying Value    | Estimated Fair Value |
| <b>Financial assets:</b>  |                    |                      |                   |                      |
| <b>Level 1 inputs:</b>  |                    |                      |                   |                      |
| Cash and cash equivalents                                       | \$86,234           | \$86,234             | \$144,293         | \$144,293            |
| <b>Level 2 inputs:</b>  |                    |                      |                   |                      |
| FHLB stock  | 17,559             | n/a                  | 17,717            | n/a                  |
| Accrued interest receivable on investments                      | 1,878              | 1,878                | 1,596             | 1,596                |
| <b>Level 3 inputs:</b>  |                    |                      |                   |                      |
| Loans receivable, net, excluding loans at fair value and leases | 408,477            | 419,138              | 435,416           | 449,676              |
| Accrued interest receivable on loans                            | 1,184              | 1,184                | 1,261             | 1,261                |
| FDIC indemnification receivable, net                            | 14,024             | 14,024               | 23,676            | 23,676               |
| <b>Financial liabilities:</b>                                   |                    |                      |                   |                      |
| <b>Level 1 inputs:</b>  |                    |                      |                   |                      |
| Demand and savings deposits                                     | 641,340            | 641,340              | 633,637           | 633,637              |
| Advances by borrowers for taxes and insurance                   | 1,321              | 1,321                | 358               | 358                  |
| Accrued interest payable  | 173                | 173                  | 219               | 219                  |
| <b>Level 2 inputs:</b>  |                    |                      |                   |                      |
| Certificates of deposit   | 217,042            | 220,720              | 272,462           | 276,822              |
| Repurchase agreements   | 4,758              | 4,785                | 4,913             | 4,982                |

The following methods and assumptions were used to estimate the fair value of each class of financial instruments:

**Cash and Cash Equivalents.** The carrying amount approximates fair value.

**FHLB Stock.** The determination of fair value of FHLB stock was impractical due to restrictions on the transferability of the stock.

**Loans Receivable.** Fair values for all performing loans are estimated using a discounted cash flow analysis, utilizing interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. In addition, the fair value reflects the decrease in loan values as estimated in the allowance for loan losses calculation. Leases are excluded from the table above. The methods utilized to estimate the fair value of loans do not necessarily represent a liquidation price.

**FDIC Indemnification Asset.** Carrying value approximates fair value as the receivable is recorded at the net present value of estimated cash flows.

**Accrued Interest Receivable.** The carrying amount approximates fair value.

Deposits. The fair value of demand deposits, savings accounts and certain money market deposits is the amount payable on demand at the reporting date. The fair value of fixed-maturity certificates of deposit are estimated using discounted cash flow analysis using the rates currently offered for deposits of similar remaining maturities.

Repurchase Agreements. The fair value of these borrowings is estimated by discounting the future cash flows using the current rate at which similar borrowings with similar remaining maturities could be made.

Advances by Borrowers for Taxes and Insurance. The carrying amount approximates fair value.

Accrued Interest Payable. The carrying amount approximates fair value.

Off-Balance Sheet Instruments. Fair values of off-balance-sheet lending commitments are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the borrower's credit standing. The fair value of the fees at September 30, 2012 and December 31, 2011, were insignificant.

#### Note 7 –FDIC Indemnification Receivable

Activity in the FDIC indemnification receivable for the three months ended September 30, 2012 and 2011 was as follows (in thousands):

|   | Reimbursement Rate |           | Amount     |             | Net        |
|---|--------------------|-----------|------------|-------------|------------|
|   | 80%                | 95%       | Receivable | Discount    | Receivable |
| Balance at June 30, 2012                        | \$ 16,877          | \$ 5,125  | \$ 18,370  | \$ --       | \$ 18,370  |
| Payments from FDIC for losses on covered assets | (810 )             | (1,270 )  | (1,855 )   | --          | (1,855 )   |
| Decrease in estimated losses                    | (1,985 )           | (951 )    | (2,491 )   | --          | (2,491 )   |
| Balance at September 30, 2012                   | \$ 14,082          | \$ 2,904  | \$ 14,024  | \$ --       | \$ 14,024  |
| Balance at June 30, 2011                        | \$ 59,643          | \$ 12,481 | \$ 59,571  | \$ (1,432 ) | \$ 58,139  |
| Payments from FDIC for losses on covered assets | (21,610 )          | (2,560 )  | (19,720 )  | --          | (19,720 )  |
| Decrease in estimated losses                    | (6,479 )           | (847 )    | (5,988 )   | --          | (5,988 )   |
| Discount accretion                              | --                 | --        | --         | 1,432       | 1,432      |
| Balance at September 30, 2011                   | \$ 31,554          | \$ 9,074  | \$ 33,863  | \$ --       | \$ 33,863  |

Activity in the FDIC indemnification receivable for the nine months ended September 30, 2012 and 2011 was as follows (in thousands):

|   | Reimbursement Rate |          | Amount     |             | Net        |
|---|--------------------|----------|------------|-------------|------------|
|   | 80%                | 95%      | Receivable | Discount    | Receivable |
| Balance at December 31, 2011                    | \$22,974           | \$5,576  | \$23,676   | \$--        | \$23,676   |
| Payments from FDIC for losses on covered assets | (1,949 )           | (1,445 ) | (2,932 )   | --          | (2,932 )   |
| Decrease in estimated losses                    | (6,943 )           | (1,227 ) | (6,720 )   | --          | (6,720 )   |
| Balance at September 30, 2012                   | \$14,082           | \$2,904  | \$14,024   | \$--        | \$14,024   |
| Balance at December 31, 2010                    | \$82,017           | \$6,705  | \$71,983   | \$ (2,437 ) | \$69,546   |
| Payments from FDIC for losses on covered assets | (40,721 )          | (2,560 ) | (35,009 )  | --          | (35,009 )  |
| Increase (decrease) in estimated losses         | (9,742 )           | 4,929    | (3,111 )   | --          | (3,111 )   |
| Discount accretion                              | --                 | --       | --         | 2,437       | 2,437      |
| Balance at September 30, 2011                   | \$31,554           | \$9,074  | \$33,863   | \$--        | \$33,863   |

For estimated losses on covered assets purchased in the CFB Acquisition, amounts receivable from the FDIC have been estimated at 80% of losses on covered assets (acquired loans and REO) up to \$34.0 million. Reimbursable losses in excess of \$34.0 million have been estimated at 95% of the amount recoverable from the FDIC. For estimated losses on covered assets purchased in the LibertyBank Acquisition, amounts receivable from the FDIC have been estimated at 80% of losses on all covered assets.

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

### Forward-Looking Statements and "Safe Harbor" statement under the Private Securities Litigation Reform Act of 1995

This report contains forward-looking statements, which can be identified by the use of words such as "believes," "intends," "expects," "anticipates," "estimates" or similar expressions. Forward-looking statements include, but are not limited to:

- statements of our goals, intentions and expectations;
- statements regarding our business plans, prospects, growth and operating strategies;
  - statements regarding the quality of our loan and investment portfolios; and
  - estimates of our risks and future costs and benefits.

These forward-looking statements are subject to significant risks and uncertainties. Actual results may differ materially from those contemplated by the forward-looking statements due to, among others, the following factors:

- the credit risks of lending activities, including changes in the level and trend of loan delinquencies and write-offs and changes in our allowance for loan losses and provision for loan losses that may be impacted by deterioration in the housing and commercial real estate markets;
  - changes in general economic conditions, either nationally or in our market areas;
  - changes in the levels of general interest rates, and the relative differences between short-term and long-term interest rates, deposit interest rates, our net interest margin and funding sources;
- risks related to acquiring assets in or entering markets in which we have not previously operated and may not be familiar;
- fluctuations in the demand for loans, the number of unsold homes and properties in foreclosure and fluctuations in real estate values in our market areas;
  - results of examinations of the Company by the Federal Reserve Board and of our bank subsidiary by the Federal Deposit Insurance Corporation (FDIC) and the Idaho Department of Finance or other regulatory authorities, including the possibility that any such regulatory authority may, among other things, require us to increase our reserve for loan losses, write-down assets, change our regulatory capital position or affect our ability to borrow funds or maintain or increase deposits, which could adversely affect our liquidity and earnings and could increase our deposit premiums;
- legislative or regulatory changes, such as the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") and its implementing regulations that adversely affect our business, as well as changes in regulatory policies and principles or the interpretation of regulatory capital or other rules, including as a result of Basel III;
  - our ability to attract and retain deposits;
  - increases in premiums for deposit insurance;
  - our ability to realize the residual values of our leases;
  - our ability to control operating costs and expenses;
- the use of estimates in determining the fair value of certain of our assets, which estimates may prove to be incorrect and result in significant declines in valuation;
  - difficulties in reducing risks associated with the loans on our balance sheet;
- staffing fluctuations in response to product demand or the implementation of corporate strategies that affect our workforce and potential associated charges;
  - computer systems on which we depend could fail or experience a security breach;
    - our ability to retain key members of our senior management team;
    - costs and effects of litigation, including settlements and judgments;
-

our ability to successfully integrate any assets, liabilities, customers, systems, and management personnel we have acquired, including the Community First Bank and LibertyBank transactions described in this report, or may in the future acquire from our merger and acquisition activities into our operations, our ability to retain clients and employees and our ability to realize related revenue synergies and cost savings within expected time frames, or at all, and any goodwill charges related thereto and costs or difficulties

relating to integration matters, including but not limited to customer and employee retention, which might be greater than expected;

- the possibility that the expected benefits from the FDIC-assisted acquisitions will not be realized;
  - increased competitive pressures among financial services companies;
  - changes in consumer spending, borrowing and savings habits;
- the availability of resources to address changes in laws, rules, or regulations or to respond to regulatory actions;
  - our ability to pay dividends on our common stock;
  - adverse changes in the securities markets and the value of our investments;
  - the inability of key third-party providers to perform their obligations to us;
- changes in accounting policies and practices, as may be adopted by the financial institution regulatory agencies or the Financial Accounting Standards Board, including additional guidance and interpretation on accounting issues and details of the implementation of new accounting methods; and
- other economic, competitive, governmental, regulatory, and technological factors affecting our operations, pricing, products and services and the other risks described as detailed from time to time in our filings with the SEC, including this our 2011 Form 10-K. Such developments could have an adverse impact on our financial position and our results of operations.

Any of the forward-looking statements that we make in this report and in other public statements we make may turn out to be wrong because of inaccurate assumptions we might make, because of the factors illustrated above or because of other factors that we cannot foresee. Because of these and other uncertainties, our actual future results may be materially different from the results indicated by these forward-looking statements and you should not rely on such statements. We undertake no obligation to publish revised forward-looking statements to reflect the occurrence of unanticipated events or circumstances after the date hereof. These risks could cause our actual results for 2012 and beyond to differ materially from those expressed in any forward-looking statements by or on behalf of us, and could negatively affect our financial condition, liquidity and operating and stock price performance.

As used throughout this report, the terms “we”, “our”, “us” or the “Company” refer to Home Federal Bancorp and its consolidated subsidiaries, unless the context otherwise requires.

## Background and Overview

Home Federal Bancorp, Inc. is a Maryland corporation that serves as the holding company for Home Federal Bank (the “Bank”). The Company’s common stock is traded on the NASDAQ Global Select Market under the symbol “HOME” and is included in the U.S. Russell 2000® Index.

The Bank is a state-chartered, FDIC-insured commercial bank and is a community-oriented financial institution dedicated to serving the financial service needs of consumers and businesses within its market areas. The Bank’s primary business is attracting deposits from the general public and using these funds to originate loans. The Bank emphasizes the direct origination of commercial business loans, commercial real estate loans, construction and residential development loans, and consumer loans.

On August 7, 2009, the Bank entered into a purchase and assumption agreement with loss share with the FDIC to assume nearly all of the deposits and certain other liabilities and acquire certain assets, including loans and real estate owned and other repossessed assets (“REO”) of Community First Bank, a full service commercial bank, headquartered in Prineville, Oregon (the “CFB Acquisition”). The loans and REO purchased are covered by loss sharing agreements between the FDIC and Home Federal Bank, which afford the Bank significant protection. Under the loss sharing agreements, Home Federal Bank will share in the losses and certain reimbursable expenses on assets covered under the agreement. The FDIC has agreed to reimburse Home Federal Bank for 80% of losses and certain reimbursable expenses on the first \$34.0 million of losses on assets covered under the agreements, and 95% of losses that exceed that amount on covered assets.

On July 30, 2010, the Bank entered into a purchase and assumption agreement with the FDIC to assume all of the deposits and certain other liabilities and acquire certain assets of LibertyBank, headquartered in Eugene, Oregon (the “LibertyBank Acquisition”). Nearly all of the loans and REO purchased are covered by loss sharing agreements.



The FDIC has agreed to reimburse Home Federal Bank for 80% of losses and certain reimbursable expenses on covered assets. The LibertyBank Acquisition has been incorporated prospectively in the Company's financial statements and significantly increased the Company's assets, income and expenses.

Nearly all of the loans and REO purchased in these acquisitions are subject to loss sharing agreements with the FDIC and are referred to herein as "covered loans" or "covered assets." Loans and REO not subject to loss sharing agreements with the FDIC are referred to as "noncovered loans" or "noncovered assets."

At September 30, 2012, Home Federal Bank had operations in three distinct market areas including Boise, Idaho, and surrounding communities, together known as the Treasure Valley region of southwestern Idaho, which we refer to as the Idaho Region. The CFB Acquisition resulted in the Bank's entrance to the Tri-County Region of Central Oregon, including the counties of Crook, Deschutes and Jefferson. We refer to this market as the Central Oregon Region. In addition to deepening its presence in Central Oregon, as a result of the LibertyBank Acquisition, the Bank also operates in Lane, Josephine, Jackson, and Multnomah counties in Oregon, including the communities of Eugene, Grants Pass and Medford, Oregon. We refer to these markets as our Western Oregon Region. At September 30, 2012, the Bank had 28 full-service branches and two commercial loan production offices located in Portland and Bend, Oregon.

The Company reported net income of \$322,000, or \$0.02 per diluted share, for the three months ended September 30, 2012, compared to a net loss of (\$2.0 million), or (\$0.13) per diluted share, for the same period a year ago. For the nine months ended September 30, 2012, the Company reported net income of \$1.6 million, or \$0.11 per diluted share, compared to a net loss of (\$3.3 million), or (\$0.21) per diluted share, for the nine months ended September 30, 2011.

The following items summarize key activities of the Company during the quarter ended September 30, 2012:

- Net interest income before the provision for loan losses increased \$1.2 million compared to the prior quarter ended June 30, 2012, due to an increase in the yield on covered loans in the current quarter. However, net interest income decreased \$4.2 million to \$11.5 million for the quarter ended September 30, 2012, when compared to the quarter ended September 30, 2011, due to a lower yield on covered loans, which was partially offset by a lower cost of funds in the third quarter of 2012;
- A negative provision for loan losses of (\$382,000) was recorded on loans purchased in the CFB Acquisition and a provision for loan losses of \$487,000 was recorded on loan pools purchased in the LibertyBank Acquisition. The provision for loan losses, net of the FDIC indemnification recovery of \$50,000, which is reported in noninterest income, reduced income before taxes by \$55,000. A provision for loan losses for originated noncovered loans was not recorded during the quarter ended September 30, 2012;
- Noninterest income during the quarter ended September 30, 2012, included impairment of the FDIC indemnification asset of \$3.0 million, which was a result of a reduction in estimated future losses on covered loans. The impairment of the FDIC indemnification asset was \$1.7 million in the linked quarter and \$6.9 million in the year-ago quarter;
- Noninterest expense decreased by \$3.1 million during the quarter ended September 30, 2012, compared to the year-ago quarter and decreased \$620,000 compared to the prior quarter due primarily to lower compensation costs in 2012 and severance costs that were accrued during the quarter ended September 30, 2011 while there were no severance costs during the quarter ended September 30, 2012. For the nine months ended September 30, 2012, noninterest expenses declined \$7.1 million compared to the nine months ended September 30, 2011;
- Total assets decreased \$14.4 million during the quarter ended September 30, 2012, compared to June 30, 2012. Total assets have declined \$56.2 million since December 31, 2011, as declines in cash and cash equivalents and loans offset reductions in deposits;
- Noncovered nonperforming assets declined \$2.3 million to \$20.7 million at September 30, 2012, compared to June 30, 2012. Total nonperforming assets decreased \$4.3 million during the current quarter to \$35.3 million at September 30, 2012; and

- The Company repurchased 721,244 shares during the quarter ended September 30, 2012, at an average cost of \$10.20 per share. The Company's board of directors authorized a new stock repurchase program,

authorizing the repurchase of up to 725,000 shares, or approximately 5%, of the Company's stock, effective October 31, 2012.

#### Critical Accounting Estimates and Related Accounting Policies

The preparation of the consolidated financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect amounts reported in the consolidated financial statements. Changes in these estimates and assumptions are considered reasonably possible and may have a material impact on the consolidated financial statements, and thus actual results could differ from the amounts reported and disclosed herein. Management has identified several accounting policies that, due to the judgments, estimates and assumptions inherent in those policies, are critical to an understanding of the Company's consolidated financial statements. These policies relate to the determination of the allowance for loan losses (including the evaluation of impaired loans and the associated provision for loan losses), accounting for acquired loans and covered assets, the valuation of real estate owned, as well as deferred income taxes and the associated income tax expense.

**Allowance for Loan Losses.** Management recognizes that losses may occur over the life of a loan and that the allowance for loan losses must be maintained at a level necessary to absorb specific losses on impaired loans and probable losses inherent in the loan portfolio. Management assesses the allowance for loan losses on a quarterly basis by analyzing several factors including delinquency rates, charge-off rates and the changing risk profile of the Company's loan portfolio, as well as local economic conditions such as unemployment rates, bankruptcies and vacancy rates of business and residential properties.

The Company believes the accounting estimate related to the allowance for loan losses is a critical accounting estimate because it is highly susceptible to change from period to period, requiring management to make assumptions about probable incurred losses inherent in the loan portfolio at the balance sheet date. The impact of a sudden large loss could deplete the allowance and require increased provisions to replenish the allowance, which would negatively affect earnings.

The Company's methodology for analyzing the allowance for loan losses consists of specific allocations on significant individual credits and a general allowance amount. The specific allowance component is determined when management believes that the collectability of an individually reviewed loan has been impaired and a loss is probable. The general allowance component relates to assets with no well-defined deficiency or weakness and takes into consideration loss that is inherent within the portfolio but has not been identified. The general allowance is determined by applying a historical loss percentage to various types of loans with similar characteristics and classified loans that are not analyzed specifically. Adjustments are made to historical loss percentages to reflect current economic and internal environmental factors such as changes in underwriting standards and unemployment rates that may increase or decrease those loss factors. As a result of the imprecision in calculating inherent and potential losses, environmental adjustments are added to the general allowance to provide an allowance for loan losses that is adequate to cover losses that may arise as a result of changing economic conditions and other qualitative factors that may alter historical loss experience.

The allowance for loan losses is increased by the provision for loan losses, which is charged against current period operating results and decreased by the amount of actual loan charge-offs, net of recoveries. Reductions in estimated or known losses may result in a reduction in the allowance for loan losses, which may be effected through a "negative" provision for loan losses. Provisions for losses on covered loans are recorded gross of recoverable amounts from the FDIC under the loss sharing agreements. The recoverable portion of the provision for loan losses on covered loans is recorded in noninterest income as "FDIC indemnification recovery."

The allowance for loan losses on noncovered originated loans consists of specific reserves allocated to individually reviewed loans and general reserves on all other noncovered originated loans. Commencing in April 2011, management changed its procedures for specific allowances on noncovered originated loans in process of foreclosure. Previously, the Bank would maintain a specific reserve on these noncovered impaired loans. Since April 2011, such deficiencies on loans in process of foreclosure are classified as "Loss" under our credit grading process and the loan balance is charged down, which removes the specific reserve previously recorded. A general allowance for loan losses is recorded on loans purchased in the CFB Acquisition that are not accounted for under Accounting Standard Codification Topic ("ASC") 310-30. Loans purchased in the CFB Acquisition that are accounted for under

ASC 310-30 are partially charged down if estimated losses exceed the fair value discount established on the acquisition date. The Company elected to apply the accounting methodology of ASC 310-30 to all loans purchased in the LibertyBank Acquisition, which is described in greater detail below under “Acquired Loans and Covered Assets.” As a result, an allowance for loans purchased in the LibertyBank Acquisition is established when the net present value of cash flows expected to be received for loans in each individual loan pool become impaired.

**Acquired Loans and Covered Assets.** Loans acquired in the CFB Acquisition were valued as of the acquisition date in accordance with Statement of Financial Accounting Standard (“SFAS”) No. 141, Business Combinations. At the time of the CFB Acquisition, the Company applied SFAS No. 141, which was superseded by SFAS No. 141(R). The Company was not permitted to adopt SFAS No. 141(R) prior to its effective date, which was October 1, 2009, due to the Company’s fiscal year end. ASC 310-30 applies to a loan with evidence of deterioration of credit quality since origination, acquired by completion of a transfer for which it is probable, at acquisition, that the investor will be unable to collect all contractually required payments receivable. Management also estimated the amount of credit losses that were expected to be realized for the loan portfolio primarily by estimating the liquidation value of collateral securing loans on non-accrual status or classified as substandard or doubtful. Loans purchased in the CFB Acquisition accounted for under ASC 310-30 were not aggregated into pools and are accounted for on a loan-by-loan basis. An allowance for loan losses was established for loans purchased in the CFB Acquisition that are not accounted for under ASC 310-30.

Loans purchased in the LibertyBank Acquisition are valued as of acquisition date in accordance with ASC 805, Business Combinations, formerly SFAS 141(R). Further, the Company elected to account for all loans purchased in the LibertyBank Acquisition within the scope of ASC 310-30 using the same methodology. Under ASC 805 and ASC 310-30, loans purchased in the LibertyBank Acquisition were recorded at fair value at acquisition date, factoring in credit losses expected to be incurred over the life of the loan. Accordingly, an allowance for loan losses was not carried over or recorded as of the acquisition date, unlike the loans purchased in the CFB Acquisition, which are accounted for under previous guidance as described above. In situations where loans have similar risk characteristics, loans were aggregated into pools to estimate cash flows under ASC 310-30. A pool is accounted for as a single asset with a single interest rate, cumulative loss rate and cash flow expectation. The Company aggregated all of the loans purchased in the LibertyBank Acquisition into 22 different pools, based on common risk characteristics such as loan classification, loan structure, nonaccrual status and collateral type.

The cash flows expected over the life of the pools are estimated using an internal cash flow model that projects cash flows and calculates the carrying values of the pools, book yields, effective interest income and impairment, if any, based on pool level events. Assumptions as to cumulative loss rates, loss curves and prepayment speeds are utilized to calculate the expected cash flows. Under ASC 310-30, the excess of the expected cash flows at acquisition over the fair value is considered to be the accretable yield and is recognized as interest income over the life of the loan or pool. The excess of the contractual cash flows over the expected cash flows is considered to be the nonaccretable difference. Subsequent increases in cash flow over those expected at purchase date in excess of fair value are recorded as an adjustment to accretable difference on a prospective basis. Any subsequent decreases in cash flow over those expected at purchase date are recognized by recording an allowance for loan losses. Any disposals of loans, including sales of loans, payments in full or foreclosures result in the removal of the loan from the ASC 310-30 portfolio at the carrying amount.

Covered loans, and provisions for loan losses, charge offs and recoveries, are reported exclusive of the expected cash flow reimbursements expected from the FDIC. Covered REO is reported exclusive of expected reimbursement cash flows from the FDIC. Upon transferring covered loan collateral to covered REO status, acquisition date fair value discounts on the related loan are also transferred to covered REO. Fair value adjustments on covered REO result in a reduction of the covered REO carrying amount and a corresponding increase in the estimated FDIC reimbursement, with the estimated net loss to the Bank charged against earnings. The Bank is reimbursed by the FDIC on losses and reimbursable expenses on covered assets purchased in the CFB Acquisition at a rate of 80% on the first \$34.0 million

of losses and at a rate of 95% on losses thereafter. The Bank is reimbursed by the FDIC on losses and reimbursable expenses on covered assets purchased in the LibertyBank Acquisition at a rate of 80%.

**FDIC Indemnification Asset.** In conjunction with the CFB Acquisition and the LibertyBank Acquisition, the Bank entered into loss sharing agreements with the FDIC for amounts receivable under the loss sharing agreements. In some cases the FDIC loss sharing agreements may be terminated on a loan by loan basis if the Bank renews or

extends individual loans. At each acquisition date the Company elected to account for amounts receivable under the loss sharing agreements as an indemnification asset. Subsequent to the acquisitions the indemnification asset is tied to the loss in the covered loans and is not being accounted for under fair value. The FDIC indemnification asset is accounted for on the same basis as the related purchased loans and is the present value of the cash flows the Company expects to collect from the FDIC under the loss sharing agreements. The difference between the present value and the undiscounted cash flow the Company expects to collect from the FDIC is accreted or amortized into noninterest income over the life of the FDIC indemnification asset.

The FDIC indemnification asset is adjusted for any changes in expected cash flows based on the loan performance. Any increases in cash flow of the loans over those expected will reduce the FDIC indemnification asset and any decreases in cash flow of the loans over those expected will increase the FDIC indemnification asset. The FDIC indemnification asset will be reduced as losses are recognized on covered assets, if losses in future periods are projected to decline, and loss sharing payments are received from the FDIC.

Real Estate Owned. Real estate properties acquired through, or in lieu of, loan foreclosure that are not covered under a loss sharing agreement with the FDIC (noncovered REO) are initially recorded at fair value at the date of foreclosure minus estimated costs to sell. Covered REO was initially recorded at fair value as of the acquisition date.

Any valuation adjustments required at the time of foreclosure are charged to the allowance for loan losses. After foreclosure, the properties are carried at the lower of carrying value or fair value less estimated costs to sell. Any subsequent valuation adjustments, operating expenses or income, and gains and losses on disposition of such properties are recognized in current operations. The valuation allowance is established based on our historical realization of losses and adjusted for current market values, which is primarily determined using recent appraisals provided by third-party appraisers.

Deferred Income Taxes. Deferred income taxes are reported for temporary differences between items of income or expense reported in the financial statements and those reported for income tax purposes. Deferred taxes are computed using the asset and liability approach as prescribed in ASC Topic 740, Income Taxes. Under this method, a deferred tax asset or liability is determined based on the enacted tax rates that will be in effect when the differences between the financial statement carrying amounts and tax basis of existing assets and liabilities are expected to be reported in an institution's income tax returns. The deferred tax provision for the year is equal to the net change in the net deferred tax asset from the beginning to the end of the year, less amounts applicable to the change in value related to investments available-for-sale. The effect on deferred taxes of a change in tax rates is recognized as income in the period that includes the enactment date. The primary differences between financial statement income and taxable income result from depreciation expense, purchase accounting adjustments, loan loss reserves, deferred compensation, mark to market adjustments on our investments available-for-sale, and dividends received from the FHLB of Seattle. Deferred income taxes do not include a liability for pre-1988 bad debt deductions allowed to thrift institutions that may be recaptured if the institution fails to qualify as a bank for income tax purposes in the future.

## Comparison of Financial Condition at September 30, 2012 and December 31, 2011

During the nine months ended September 30, 2012, total assets decreased \$56.2 million, or 5.0%, to \$1.1 billion at September 30, 2012 compared to December 31, 2011. The changes in total assets were primarily concentrated in the following asset categories (dollars in thousands):

|  | September<br>30, 2012 | December 31,<br>2011 | Increase/(Decrease) |          |
|--|-----------------------|----------------------|---------------------|----------|
|  |                       |                      | Amount              | Percent  |
| Cash and amounts due from depository institutions  | \$ 86,234             | \$ 144,293           | \$ (58,059 )        | (40.2 )% |
| Investments, at fair value                         | 444,449               | 399,877              | 44,572              | 11.1     |
| Loans receivable, net of allowance for loan losses | 420,232               | 449,908              | (29,676 )           | (6.6 )   |
| FDIC indemnification receivable, net               | 14,024                | 23,676               | (9,652 )            | (40.8 )  |

**Cash and Amounts Due From Depository Institutions.** The \$58.1 million decrease in cash and equivalents during the nine months ended September 30, 2012, was due to the purchase of investments and payments on maturing certificates of deposit that were not renewed, reflecting our strategy of allowing higher cost certificates of deposit to decline. These cash outflows were partially offset by proceeds received from loan payments and other operating income. We anticipate, subject to market conditions, that we will conserve some liquidity in order to meet the demand of maturing certificates of deposit, prepare for the potential of rising interest rates, and to provide flexibility for potential acquisitions and repurchases of common stock.

Balances on deposit at the Federal Reserve Bank of San Francisco totaled \$77.6 million and \$130.6 million at September 30, 2012, and December 31, 2011. Currently, balances on deposit with the Federal Reserve Bank that are in excess of our required reserve balances earn interest at a rate that approximates the federal funds rate. In 2009, in response to the national banking crisis, the Board of Governors amended Regulation D, which established excess balance accounts. Previously, excess balances on deposit with the Federal Reserve did not earn interest. The excess balance accounts are intended to be temporary accounts to assist financial institutions during the economic crisis. Since 2008, we have placed excess cash balances with the Federal Reserve in order to reduce credit risk exposure to other financial institutions. While the Board of Governors of the Federal Reserve Bank has not set a date for expiration of these accounts, we could experience a decline in interest income once the Federal Reserve discontinues interest payments on excess balances. Additionally, once these accounts expire, we may place excess cash on deposit with other financial institutions that do not have a guarantee from the U.S. Government, or we may purchase investments in order to earn interest on excess liquidity currently earning interest on deposit with the Federal Reserve Bank.

**Investments.** Investments available-for-sale increased \$44.6 million during the nine months ended September 30, 2012. Mortgage-backed securities issued by U.S. Government-sponsored enterprises increased \$21.7 million during the first nine months of 2012, while securities issued by state and local political subdivisions increased an additional \$20.8 million during that time period. Additionally, we have structured our investment portfolio to mitigate price sensitivity to protect capital if we need to sell significant amounts of investments in the future to increase liquidity. At September 30, 2012, the estimated effective duration of our investment portfolio was 3.0 years.

We continually analyze our investment portfolio to improve and optimize total return. During the nine months ended September 30, 2012, we were able to purchase and sell U.S. Treasury notes and some mortgage-backed securities, recording pre-tax gains of \$1.2 million due to the price volatility and a strong rally in the bond market during this



period.

Loans and Leases Receivable. Loans and leases receivable, net, decreased by \$30.0 million, or 6.6%, during the nine months ended September 30, 2012. One-to-four family residential loans decreased by \$20.3 million while commercial real estate loans declined by \$21.8 million. Commercial business loans decreased by \$11.6 million. Partially offsetting these decreases, multifamily residential loans increased \$14.4 million and construction loans increased \$13.4 million during the first nine months of 2012. In March 2012, the Bank opened a loan production office in Portland, Oregon, and hired a construction loan officer to expand the Bank's builder finance commercial loan program in that market. During the nine months ended September 30, 2012, covered loans declined \$40.8 million to \$99.2 million and noncovered loans increased \$9.0 million to \$333.5 million.

New loan production increased during the second and third quarters of fiscal year 2012 and the new construction loan production office in Portland has had a strong start. Nonetheless, payments on the one-to-four family residential loan portfolio and the loan and lease portfolio of the Bank's subsidiary, Commercial Equipment Lease Corporation, continue to cause a net reduction in outstanding loan balances since we no longer originate loans for those noncore portfolios. The economies in our primary markets appear to have stabilized and are showing some signs of improvement; however, this improving outlook is still tenuous and future meaningful net loan growth is still somewhat uncertain.

**Allowance for Loan Losses and Asset Quality.** The allowance for loan losses decreased to \$12.6 million at September 30, 2012, from \$14.2 million at December 31, 2011, as the quality of our loan portfolio continues to show signs of improvement. At September 30, 2012, the allowance on originated, noncovered loans was \$8.6 million, compared to \$9.9 million at December 31, 2011. The allowance for loan losses on the originated, noncovered loan portfolio was 2.57% of originated, noncovered loans at September 30, 2012, with \$1.2 million of the \$8.6 million allowance for originated noncovered loan losses specifically-allocated to impaired loans. The allowance for originated, noncovered loans decreased during the nine months ended September 30, 2012, due to net charge-offs of \$1.3 million. However, these charge-offs did not require an additional provision during the first nine months of 2012 as impaired loans and general asset quality metrics have improved and the economy in the Boise market, where most of our originated, noncovered loans are located, is showing signs of stabilization and improvement during 2012. Noncovered loans classified as "Substandard" and "Special Mention" under the Bank's classification policy, declined \$10.0 million and \$8.0 million, respectively, during the nine months ended September 30, 2012, representing declines of 24% and 38%, respectively. Delinquent noncovered loans have declined during fiscal year 2012, as well. In particular, the estimated losses in our commercial real estate and construction loan portfolios have declined with economic stabilization in Boise, which has resulted in a decline in the allowance for loan losses allocated to those portfolios.

The allowance on covered loans purchased in the CFB Acquisition totaled \$1.2 million at September 30, 2012, down from \$1.7 million at December 31, 2011. Gross charge-offs of covered loans purchased in the CFB Acquisition totaled \$1.1 million during the nine months ended September 30, 2012; however, recoveries on covered loans purchased in the CFB Acquisition totaled \$2.5 million during this nine month period, which resulted in net recoveries of \$1.4 million. Accordingly, a negative provision for loan losses on covered loans purchased in the CFB Acquisition of \$1.9 million was recorded during the nine months ended September 30, 2012, with most of the provision being offset in noninterest income as the FDIC indemnification provision.

An allowance of \$2.8 million was recorded on covered loans purchased in the LibertyBank Acquisition at September 30, 2012, which was an increase of \$300,000 compared to December 31, 2011. Loans purchased in the LibertyBank Acquisition were aggregated at the time of acquisition into 22 pools and each pool is accounted for as a single asset with a single interest rate, cumulative loss rate and cash flow expectation. An allowance for loan losses has since been established on certain loan pools purchased in the LibertyBank Acquisition because the net present value of cash flows expected to be received from loans in certain individual pools were impaired at September 30, 2012, when compared to the original estimated cash flows for each pool. An \$822,000 provision for loan losses on covered loans purchased in the LibertyBank Acquisition was recorded during the nine months ended September 30, 2012.

Loans delinquent 30 to 89 days and still accruing interest totaled \$705,000 at September 30, 2012, compared to \$2.1 million at December 31, 2011, including \$249,000 and \$311,000, respectively, of covered loans in the Community First Bank loan portfolio. Noncovered nonperforming loans decreased to \$14.4 million at September 30, 2012, compared to \$15.7 million at December 31, 2011. Covered nonperforming loans decreased to \$6.6 million at September 30, 2012, compared to \$10.4 million at December 31, 2011. Nonperforming assets, which include nonperforming loans and REO, totaled \$35.3 million at September 30, 2012, compared to \$46.0 million at December 31, 2011.



The following table summarizes nonperforming assets at September 30, 2012 and December 31, 2011 (in thousands):

|  | September 30, 2012       |                      |          | December 31, 2011        |                      |          | Year-to-Date Change      |                      |
|--|--------------------------|----------------------|----------|--------------------------|----------------------|----------|--------------------------|----------------------|
|  | Covered<br>Assets<br>(1) | Noncovered<br>Assets | Total    | Covered<br>Assets<br>(1) | Noncovered<br>Assets | Total    | Covered<br>Assets<br>(1) | Noncovered<br>Assets |
| Real estate construction               | \$254                    | \$ 866               | \$1,120  | \$2,007                  | \$ 1,547             | \$3,554  | \$(1,753 )               | \$( 681 )            |
| Commercial and multifamily real estate | 5,934                    | 8,698                | 14,632   | 7,306                    | 7,601                | 14,907   | (1,372 )                 | 1,097                |
| One- to four-family residential        | 348                      | 3,671                | 4,019    | 753                      | 5,446                | 6,199    | (405 )                   | (1,775 )             |
| Other                                  | 96                       | 1,212                | 1,308    | 374                      | 1,100                | 1,474    | (278 )                   | 112                  |
| Total nonperforming loans              | 6,632                    | 14,447               | 21,079   | 10,440                   | 15,694               | 26,134   | (3,808 )                 | (1,247 )             |
| REO and other repossessed assets       | 7,886                    | 6,299                | 14,185   | 13,427                   | 6,400                | 19,827   | (5,541 )                 | (101 )               |
| Total nonperforming assets             | \$14,518                 | \$ 20,746            | \$35,264 | \$23,867                 | \$ 22,094            | \$45,961 | \$(9,349 )               | \$( 1,348 )          |

(1) Nonperforming covered assets in this table include loans purchased in the CFB Acquisition, except for those nonperforming loans accounted for under ASC 310-30, and all covered REO and repossessed assets, including REO purchased in the LibertyBank Acquisition. Loans acquired in the LibertyBank Acquisition have been pooled and are not separately reported as nonperforming loans since each pool is the unit of account under ASC 310-30.

Certain loan modifications or restructurings are accounted TDRs. In general, the modification or restructuring of a debt is considered a TDR if we, for economic or legal reasons related to a borrower's financial difficulties, grant a concession to the borrower that we would not otherwise consider. TDRs totaled \$11.1 million and \$9.1 million at September 30, 2012 and December 31, 2011, respectively. All TDRs are considered to be impaired loans, but may not necessarily be placed on nonaccrual status.

REO and other repossessed assets decreased \$5.6 million to \$14.2 million at September 30, 2012, compared to \$19.8 million at December 31, 2011. At September 30, 2012, REO was comprised primarily of \$5.7 million of commercial real estate, \$4.9 million of land development and construction projects and \$3.5 million of one-to-four family residential properties.

FDIC Indemnification Receivable. The decrease in the FDIC indemnification receivable during the nine months ended September 30, 2012, was due to the receipt of payments on loss claims made to the FDIC and due to the net reduction in estimated future losses on covered assets, which caused an impairment charge of \$8.0 million during the nine months ended September 30, 2012. The impairment in the FDIC indemnification asset recognizes the decreased amount that the Company expects to collect from the FDIC under the terms of its loss sharing agreements due to lower expected losses on covered assets recognized in noninterest income. At September 30, 2012, the FDIC indemnification receivable for estimated losses on covered assets in the LibertyBank Acquisition totaled \$11.3 million, while the receivable for estimated losses on covered assets in the CFB Acquisition was \$2.7 million.

Deposits. Deposits decreased \$47.7 million to \$858.4 million during the nine months ended September 30, 2012. Balances in certificates of deposit declined during the first nine months of the year by \$55.4 million to \$217.0 million while core deposits (defined as checking, savings and money market accounts) increased \$7.7 million between December 31, 2011 and September 30, 2012. Core deposits comprised 74.7% of total deposits at September 30, 2012 compared to 69.9% at December 31, 2011. The decrease in certificates of deposit was primarily attributable to the Bank's marketing strategy to compete less aggressively on time deposit interest rates to allow higher costing certificates of deposit to decline, in particular those acquired as part of the LibertyBank Acquisition. Our retail team attempts to retain maturing certificate of deposit relationships that include a core deposit account. We are reluctant, however, to compete for high-rate single account certificate of deposit customers due to our strong liquidity position at September 30, 2012, and consequently expect a continued managed reduction in these accounts.

The following table details the composition of the deposit portfolio and changes in deposit balances as of the balance sheet dates presented (dollars in thousands):

|                            | September<br>30, 2012 | December 31,<br>2011 | Increase/(Decrease) |         |
|----------------------------|-----------------------|----------------------|---------------------|---------|
|                            |                       |                      | Amount              | Percent |
| Noninterest-bearing demand | \$ 141,381            | \$ 127,553           | \$ 13,828           | 10.8 %  |
| Interest-bearing demand    | 245,901               | 249,215              | (3,314 )            | (1.3 )  |
| Money market               | 174,008               | 178,377              | (4,369 )            | (2.4 )  |
| Savings                    | 80,050                | 78,492               | 1,558               | 2.0     |
| Certificates of deposit    | 217,042               | 272,462              | (55,420 )           | (20.3 ) |
| Total deposit accounts     | \$ 858,382            | \$ 906,099           | \$ (47,717 )        | (5.3 )% |

Equity. Stockholders' equity decreased \$7.6 million during the past nine months to \$183.6 million at September 30, 2012, compared to \$191.3 million at December 31, 2011. The decrease in stockholders' equity was primarily due to the repurchase of 1,168,513 shares at a total cost of \$11.5 million and dividends paid of \$2.5 million. These declines in net equity were partially offset by net income from operations of \$1.6 million and an increase in the unrealized gain on our investments available-for-sale of \$3.5 million, net of taxes. All other equity items increased \$1.3 million, net.

At September 30, 2012, the Company's total risk-based capital ratio was 38.61%; Tier 1 capital to risk-weighted assets ratio was 37.34%; and Tier 1 capital to average asset ratio was 15.42%. The Bank's total risk-based capital ratio was 33.66%; Tier 1 capital to risk-weighted assets ratio was 32.39%; and Tier 1 capital to average asset ratio was 13.49%. The Bank was categorized as "Well-Capitalized" at September 30, 2012 under the regulations of the FDIC.

#### Comparison of Operating Results for the Three Months Ended September 30, 2012 and 2011

Net income for the three months ended September 30, 2012, was \$322,000, or \$0.02 per diluted share, compared to a net loss of (\$2.0 million), or (\$0.13) per diluted share, for the same period last year. Net interest margin increased to 4.74% during the quarter ended September 30, 2012, from 4.17% in the prior quarter, but decreased substantially from 5.62% during the quarter ended September 30, 2011. Similarly, the Company's yield on earning assets increased to 5.11% in the current quarter from 4.57% in the prior quarter, but declined from 6.30% during the quarter ended September 30, 2011.

Net interest margin is significantly enhanced by accretable income on purchased loans. This additional income stems from the discount established at the time these loan portfolios were acquired and the related impact of prepayments on purchased loans. Each quarter the Company analyzes the cash flow assumptions on loan pools purchased in the LibertyBank Acquisition and at least semi-annually, the Company updates loss estimates, prepayment speeds and other variables when analyzing cash flows. As a result, income from loan pools can be volatile. In addition to this accretion income, which is recognized over the estimated life of the loan pools, if a loan is removed from a pool due to payoff or foreclosure, the unaccreted discount in excess of losses is recognized as an accretion gain in interest income. During the quarter ended September 30, 2011, the Company experienced significant prepayments on pooled loans, which resulted in accretion gains. These accretion gains were less during the quarter ended September 30, 2012, but still significant.

Net Interest Income. Net interest income before the provision for loan losses decreased \$4.2 million, or 26.8%, to \$11.5 million for the quarter ended September 30, 2012, compared to \$15.8 million for the same quarter of the prior year. The decrease was attributable to the incremental accretion income from loans purchased in the LibertyBank Acquisition due to a recast during the three months ended September 30, 2011.



The following table sets forth the impact to the Company's net interest income from changes in balances of interest-earning assets and interest-bearing liabilities as well as changes in interest rates. The rate column shows the effect attributable to changes in rate (changes in rate multiplied by prior volume). The volume column shows the effect attributable to changes in volume (changes in volume multiplied by prior rate). Changes attributable to both rate and volume, which cannot be segregated, are allocated proportionately to changes in rate and volume (in thousands).

| Three Months Ended September 30, 2012<br>Compared to Three Months Ended<br>September 30, 2011 |                            |           |             |
|---|----------------------------|-----------|-------------|
|   | Increase/(Decrease) Due to |           | Total       |
|   | Rate                       | Volume    |             |
| <b>Interest-earning assets:</b>   |                            |           |             |
| Loans receivable, net   | \$ (4,310 )                | \$ (947 ) | \$ (5,257 ) |
| Loans held for sale   | -                          | (9 )      | (9 )        |
| Interest-bearing deposits in other banks  | (11 )                      | (66 )     | (77 )       |
| Investments available-for-sale  | (81 )                      | 214       | 133         |
| Total net change in income on interest-earning assets   | \$ (4,402 )                | \$ (808 ) | (5,210 )    |
| <b>Interest-bearing liabilities:</b>  |                            |           |             |
| Savings deposits  | \$ (20 )                   | \$ --     | (20 )       |
| Interest-bearing demand deposits  | (51 )                      | 2         | (49 )       |
| Money market accounts   | (119 )                     | (3 )      | (122 )      |
| Certificates of deposit   | 95                         | (394 )    | (299 )      |
| Total deposits  | (95 )                      | (395 )    | (490 )      |
| FHLB advances and other borrowings  | (5 )                       | (486 )    | (491 )      |
| Total net change in expense on interest-bearing liabilities                                   | \$ (100 )                  | \$ (881 ) | (981 )      |
| Total net change in net interest income   |                            |           | \$ (4,229 ) |

Interest Income. Total interest income for the three months ended September 30, 2012, decreased \$4.2 million, to \$11.5 million, from \$15.8 million for the three months ended September 30, 2011. The decrease during the quarter compared to the year-ago quarter was primarily attributable to a lower yield earned on loans in the LibertyBank Acquisition and as a result of an average balance of interest earning assets that was \$147.5 million lower in the current period compared to the same period in 2011. The following table compares detailed average earning asset balances, associated yields, and resulting changes in interest income (dollars in thousands):

|  | For the Three Months Ended September 30, |       |   |                    |       |   | Increase/<br>(Decrease)<br>in |
|--|--|-------|---|--------------------|-------|---|-------------------------------|
|  | 2012                                     |       |   | 2011               |       |   | Interest<br>Income            |
|  | Average<br>Balance                       | Yield |   | Average<br>Balance | Yield |   |                               |
| Loans receivable, net of deferred fees   | \$ 436,483                               | 9.30  | % | \$ 490,662         | 12.56 | % | \$ (5,257 )                   |
| Loans held for sale                      | --                                       | --    |   | 909                | 4.14  |   | (9 )                          |
| Interest bearing deposits in other banks | 74,735                                   | 0.20  |   | 208,160            | 0.22  |   | (77 )                         |
| Investments, available-for-sale          | 444,741                                  | 2.02  |   | 403,754            | 2.10  |   | 133                           |



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|                               |            |      |   |              |      |   |             |
|-------------------------------|------------|------|---|--------------|------|---|-------------|
| FHLB stock                    | 17,705     | --   |   | 17,717       | --   |   | --          |
| Total interest-earning assets | \$ 973,664 | 5.11 | % | \$ 1,121,202 | 6.30 | % | \$ (5,210 ) |

The average yield on loans decreased during the current quarter compared to the quarter ended September 30, 2011, due to accretion of discounts on purchased loans in the LibertyBank Acquisition. During the quarter ended September 30, 2011, the Company experienced significant prepayments on pooled loans, which resulted in accretion gains in that period.

Interest Expense. Managed reduction in certificates of deposits combined with lower average interest-bearing core deposits resulted in a reduced cost of funds during the quarter ended September 30, 2012, compared to the same period in 2011. Additionally, the Bank paid off all outstanding borrowings with the FHLB in September 2011, which reduced interest expense on borrowings during the quarter ended September 30, 2012 compared to the same period in 2011. The cost of funds on interest-bearing liabilities for the quarter ended September 30, 2012 was 0.50%

compared to 0.85% for the quarter ended September 30, 2011. We anticipate continued declines in certificates of deposit balances in the next quarter as maturities of these accounts continue. The following table details average balances, cost of funds and the change in interest expense (dollars in thousands):

|                                    | For the Three Months Ended September 30,<br>2012 |      |   | 2011               |      | Decrease in<br>Interest<br>Expense |
|------------------------------------|--|------|---|--------------------|------|------------------------------------|
|                                    | Average<br>Balance                               | Rate |   | Average<br>Balance | Rate |                                    |
| Savings deposits                   | \$80,946   | 0.05 | % | \$80,761           | 0.15 | % \$(20 )                          |
| Interest-bearing demand deposits   | 243,763  | 0.16 |   | 240,080            | 0.24 | (49 )                              |
| Money market deposits              | 176,888  | 0.16 |   | 180,026            | 0.42 | (122 )                             |
| Certificates of deposit            | 221,969  | 1.29 |   | 343,785            | 1.18 | (299 )                             |
| FHLB advances and other borrowings | 4,744  | 1.43 |   | 48,460             | 4.19 | (491 )                             |
| Total interest-bearing liabilities | \$728,310  | 0.50 | % | \$893,112          | 0.85 | % \$(981 )                         |

The decline in average certificates of deposits during the three months ended September 30, 2012 compared to the three months ended September 30, 2011, was due to maturities of certificates of deposit, primarily in the LibertyBank Acquisition deposit portfolio. Due to the significant amount of cash we received in the LibertyBank Acquisition, the current low interest rate environment, and weak loan demand from creditworthy borrowers, we reduced our rates on deposits during the fiscal year ended September 30, 2011, and have continued to reduce rates throughout 2012, permitting certificates of deposit to decline. As noted earlier, we repaid all outstanding advances from the FHLB during the fiscal year ended September 30, 2011. At September 30, 2012, borrowings consisted of retail repurchase agreements.

**Provision for Loan Losses.** A provision for loan losses of \$105,000 was recorded during the quarter ended September 30, 2012, compared to a provision of \$2.6 million for the year-ago period. The provision recorded during the quarter ended September 30, 2012, is comprised of a negative provision of (\$382,000) related to recoveries on loans purchased in the CFB Acquisition that was more than offset by a provision of \$487,000 on loan pools purchased in the LibertyBank Acquisition. Net of amounts recorded in noninterest income as FDIC indemnification recovery, the impact of the provision for loan losses decreased income before taxes by \$55,000 during the quarter ended September 30, 2012. The “FDIC indemnification recovery” of \$50,000 reported in noninterest income represents the offset to the provision for loan losses expected to be recovered by us from the FDIC.

Loans purchased in the LibertyBank Acquisition were aggregated into pools. If an individual pool performs better than management’s original estimates, the Company may incur an increase in accretable yield in interest income, which is offset somewhat by impairment in the FDIC indemnification asset since loan losses are expected to be less than previously estimated. If the estimated cash flows in a loan pool are less than management previously estimated, an allowance for loan losses may be recorded through a provision, which is offset somewhat by the amount expected to be recovered from the FDIC under the loss sharing agreements. During the quarter ended September 30, 2012, the Bank recognized \$487,000 in impairments on certain loan pools purchased in the LibertyBank Acquisition. These impairments were partially offset by an indemnification recovery of \$413,000. We recognized provisions for loan losses on certain pools of loans purchased in the LibertyBank Acquisition of \$2.3 million during the quarter ended September 30, 2011, which was partially offset by an indemnification recovery of \$1.9 million.

Stabilizing credit quality and an improving economy have reduced the likelihood of additional losses in the noncovered, originated loan portfolio at September 30, 2012. Therefore, we did not record a provision for noncovered, originated loans during the quarter ended September 30, 2012, compared to a provision of \$22,000 in the same 2011 period.



The following table details the impact of the provision for loan losses and the FDIC indemnification recovery on income before taxes (in thousands):

|   | For the Three Months Ended<br>September 30, |        |
|---|---|--------|
|   | 2012  | 2011   |
| Provision for loan losses on:                                       |   |        |
| Noncovered originated loans   | \$ --                                       | \$ 22  |
| Covered loans – CFB Acquisition                                     | (382 )                                      | 220    |
| Covered loans – LibertyBank Acquisition                             | 487   | 2,343  |
| Total gross provision for loan losses                               | 105   | 2,585  |
| Less: FDIC indemnification recovery reported in noninterest income: |   |        |
| Noncovered originated loans   | --  | --     |
| Covered loans – CFB Acquisition                                     | (363 )                                      | 209    |
| Covered loans – LibertyBank Acquisition                             | 413   | 1,869  |
| Total FDIC indemnification recovery                                 | 50  | 2,078  |
| Net decrease (increase) to income before taxes:                     |   |        |
| Noncovered originated loans   | --  | 22     |
| Covered loans – CFB Acquisition                                     | (19 )                                       | 11     |
| Covered loans – LibertyBank Acquisition                             | 74  | 474--  |
| Net decrease in income before income taxes                          | \$ 55                                       | \$ 507 |

While we believe the estimates and assumptions used in our determination of the adequacy of the allowance for loan losses are reasonable, there can be no assurance that such estimates and assumptions will not be proven incorrect in the future, or that the actual amount of future provisions will not exceed the amount of past provisions or that any increased provision that may be required will not adversely impact the Company's financial condition and results of operations. In addition, the determination of the amount of the allowance for loan losses is subject to review by bank regulators, as part of the routine examination process, which may result in the establishment of additional reserves based upon their judgment of information available to them at the time of their examination.

Noninterest Income. The following table provides a detailed analysis of the changes in components of noninterest income (dollars in thousands):

|   | Three Months Ended<br>September 30, |            | Increase/(Decrease) |          |
|---|-------------------------------------|------------|---------------------|----------|
|   | 2012                                | 2011       | Amount              | Percent  |
| Service charges and fees                            | \$2,110                             | \$2,685    | \$(575 )            | (21.4 )% |
| Gain on sale of loans                               | --                                  | 194        | (194 )              | (100.0 ) |
| Gain on sale of investments available-for-sale      | 79                                  | 607        | (528 )              | (87.0 )  |
| Gain on sale of fixed assets and repossessed assets | 182                                 | 61         | 121                 | 198.4    |
| FDIC indemnification recovery                       | 50                                  | 2,078      | (2,028 )            | (97.6 )  |
| Impairment of FDIC indemnification asset            | (2,994 )                            | (6,915 )   | 3,921               | 56.7     |
| Prepayment penalty on borrowings                    | --                                  | (2,007 )   | 2,007               | 100.0    |
| Other   | 222                                 | 238        | (16 )               | (6.7 )   |
| Total noninterest income                            | \$(351 )                            | \$(3,059 ) | \$2,708             | (88.5 )% |

The following table presents noninterest income excluding the impact of FDIC indemnification items on all covered loans (in thousands):

|  | Three Months Ended<br>September 30, |             |
|--|-------------------------------------|-------------|
|  | 2012                                | 2011        |
| Total noninterest income, as reported                          | \$ (351 )                           | \$ (3,059 ) |
| Less: FDIC indemnification recovery                            | 50                                  | 2,078       |
| Impairment of FDIC indemnification asset                       | (2,994 )                            | (6,915 )    |
| Total noninterest income, excluding FDIC indemnification items | \$ 2,593                            | \$ 1,778    |

As noted earlier, the FDIC indemnification recovery represents the recovery of amounts expected from the FDIC under loss sharing agreements due to incremental provisions for loan losses in the current period or the impairment (reduction) in the expected amounts to be recovered from the FDIC due to a negative provision in the current period. Impairment of the FDIC indemnification asset generally relates to the reduction in the amounts estimated to be received from the FDIC on pooled loans as a result of increases in cash flows. Since we experienced significant payoffs of loans in 2011, which caused an increase in interest income as noted above, we recognized we would not incur additional losses on those loans and would not receive recovery payments from the FDIC as a result. Therefore, the impairment of the FDIC indemnification asset was higher in 2011 compared to 2012.

Service charges and fee income decreased \$575,000 to \$2.1 million for the quarter ended September 30, 2012, compared to the quarter ended September 30, 2011. Compared to the year-ago quarter, overdraft fees were \$355,000 lower in the quarter ended September 30, 2012. The continued decline in overdraft fees was due to fewer “free checking” accounts and regulatory changes that were first implemented in July 2010. Subsequent guidance from bank regulatory agencies and the Company’s risk management practices have caused further reductions in overdraft fees as fewer clients qualify for participation in the Bank’s extended overdraft program. Service charges and fee income also declined due to a high level of income from our merchant banking and investment services during the quarter ended September 30, 2011 that did not recur in 2012. Together, fees from these services were \$190,000 lower in the quarter ended September 30, 2012, compared to 2011. The 2011 period also included in service charges and fees incentive income related to the conversion of our merchant banking platform during fiscal year 2011.

Noninterest income includes pre-tax gains on sales of investments of \$79,000 during the quarter ended September 30, 2012, compared to \$607,000 for the quarter ended September 30, 2011. During the quarter ended September 30, 2012, we identified several mortgage-backed securities that had a high level of delinquent loans within the underlying collateral pools. While these investments were guaranteed by the Ginnie Mae, we elected to sell the mortgage-backed securities at a gain rather than wait for repayment of the loans that default. During the quarter ended September 30, 2011, we identified approximately \$27.6 million of mortgage-backed securities that evidenced a significant risk of prepayment and the possibility of negative recorded yields due to accelerated amortization of the purchase premiums on those investments if the prepayment speeds accelerated. As a result, we sold those investments at a gain to avoid the risk of negative recorded yields.

We changed our method of originating mortgage loans in January 2012. Previously, we directly originated one-to-four family residential loans for resale in the secondary market. Starting in January 2012, we now refer mortgage applications to a third party originator. As a result, we no longer report gains on sale of loans. The gain on sale of fixed assets and REO was \$182,000 during the quarter ended September 30, 2012, compared to a gain on sale of fixed assets and REO of \$61,000 during the same period a year earlier.

The Bank repaid its \$48.3 million of outstanding borrowings with the FHLB on September 22, 2011. The prepayment penalty was \$2.0 million recognized during the three months ended September 30, 2011.

Noninterest Expense. Noninterest expense for the quarter ended September 30, 2012, decreased \$3.0 million or 22.6% to \$10.5 million compared to \$13.5 million for the quarter ended September 30, 2011, due to a significant reduction in personnel and integration costs as a result of the consolidation of operating systems of the acquired operations of LibertyBank and Community First Bank.

The following table provides a detailed analysis of the changes in components of noninterest expense (dollars in thousands):

|                             | Three Months Ended<br>September 30, |           | Increase/(Decrease) |          |
|-----------------------------|-------------------------------------|-----------|---------------------|----------|
|                             | 2012                                | 2011      | Amount              | Percent  |
| Compensation and benefits   | \$ 5,717                            | \$ 7,081  | \$ (1,364 )         | (19.3 )% |
| Occupancy and equipment     | 1,466                               | 1,656     | (190 )              | (11.5 )  |
| Data processing             | 920                                 | 964       | (44 )               | (4.6 )   |
| Advertising                 | 219                                 | 474       | (255 )              | (53.8 )  |
| Postage and supplies        | 210                                 | 351       | (141 )              | (40.2 )  |
| Professional services       | 678                                 | 587       | 91                  | 15.5     |
| Insurance and taxes         | 503                                 | 502       | 1                   | 0.2      |
| Amortization of intangibles | 137                                 | 168       | (31 )               | (18.5 )  |
| Provision for REO           | 56                                  | 86        | (30 )               | (34.9 )  |
| Other                       | 580                                 | 1,675     | (1,095 )            | (65.4 )  |
| Total noninterest expense   | \$ 10,486                           | \$ 13,544 | \$ (3,058 )         | (22.6 )% |

Compensation and benefits expense decreased \$1.4 million during the quarter ended September 30, 2012, compared to the year ago quarter due to branch closings and the consolidation of operations that occurred during calendar year 2011. We closed five branches in December 2011, which resulted in less compensation expense in 2012. We announced and planned those closures during the quarter ended September 30, 2011, and, accordingly, recorded severance accruals of \$225,000 during that period.

Additionally, on September 30, 2011, we merged our employee stock ownership (“ESOP”) and 401(k) plans into a single plan (“KSOP”) and refinanced the loans associated with the ESOP, which lowered the annual allocation of ESOP shares, compared to previous years. Compensation expense related to the KSOP was \$203,000 during the quarter ended September 30, 2012, compared to \$364,000 in the year-ago quarter for ESOP and 401(k) plan expenses. Expense related to the ESOP is recorded based on the fair value of the Company’s share price and, therefore, is subject to fluctuation in future periods.

Other operating expenses were \$1.1 million lower during the three months ended September 30, 2012 compared to the same period in 2011 which included \$1.1 million in charges related to branch closures announced in September 2011. All other operating expenses, net, were \$599,000 less during the quarter ended September 30, 2012, compared to the same period in the prior year, primarily due to fewer branches and employees in the 2012 period.

# Comparison of Operating Results for the Nine Months Ended September 30, 2012 and 2011

Net income for the nine months ended September 30, 2012, was \$1.6 million, or \$0.11 per diluted share, compared to a net loss of \$3.3 million, or \$0.21 per diluted share, for the same period last year. Net interest margin increased to 4.61% during the nine months ended September 30, 2012, compared to 3.69% during the same period a year earlier.

Net Interest Income. Net interest income before the provision for loan losses increased \$517,000, or 1.5%, to \$34.2 million for the nine months ended September 30, 2012, compared to \$33.7 million for the same nine months of the prior year. The increase was attributable primarily to a lower cost of funds and incremental accretion income from loans purchased in the LibertyBank Acquisition. These increases were nearly offset by declines in outstanding loan balances during the nine months ended September 30, 2012.

The following table sets forth the impact to the Company's net interest income from changes in balances of interest-earning assets and interest-bearing liabilities as well as changes in interest rates. The rate column shows the effect attributable to changes in rate (changes in rate multiplied by prior volume). The volume column shows the effect attributable to changes in volume (changes in volume multiplied by prior rate). Changes attributable to both rate and volume, which cannot be segregated, are allocated proportionately to changes in rate and volume (in thousands).

|   | Nine Months Ended September 30, 2012<br>Compared to Nine Months Ended<br>September 30, 2011<br>Increase/(Decrease) Due<br>to |           |           |
|---|--|-----------|-----------|
|   | Rate   | Volume    | Total     |
| <b>Interest-earning assets:</b>                             |  |           |           |
| Loans and leases receivable, net                            | \$1,889  | \$(4,107) | \$(2,218) |
| Loans held for sale   | --   | (17)      | (17)      |
| Interest-bearing deposits in other banks                    | (15)   | (173)     | (188)     |
| Investments available-for-sale                              | (158)  | (2)       | (160)     |
| Total net change in income on interest-earning assets       | \$1,716  | \$(4,299) | \$(2,583) |
| <b>Interest-bearing liabilities:</b>                        |  |           |           |
| Savings deposits  | \$(61)   | \$--      | (61)      |
| Interest-bearing demand deposits                            | (177)  | (5)       | (182)     |
| Money market accounts                                       | (229)  | (3)       | (232)     |
| Certificates of deposit                                     | 219  | (1,285)   | (1,066)   |
| Total deposits  | (248)  | (1,293)   | (1,541)   |
| FHLB advances and other borrowings                          | (16)   | (1,543)   | (1,559)   |
| Total net change in expense on interest-bearing liabilities | \$(264)  | \$(2,836) | \$(3,100) |
| Total increase in net interest income                       |  |           | \$517     |

Interest Income. Total interest income for the nine months ended September 30, 2012, decreased \$2.6 million, to \$37.2 million, from \$39.8 million for the nine months ended September 30, 2011. The decrease during the first nine months of 2012 was primarily attributable to a \$176.4 million decrease in interest-earning assets, partially offset by a 47 basis point increase in the yield earned on those assets to 5.02% for the nine months ended September 30, 2012, as a result of a higher yield on loans through accretable income on purchased loan pools.





The following table compares detailed average earning asset balances, associated yields, and resulting changes in interest income (dollars in thousands):

|  | For the Nine Months Ended September 30, |        |      |                 |             |                 |
|--|---|--------|------|-----------------|-------------|-----------------|
|  | 2012                                    |        | 2011 |                 | Decrease in |                 |
|  | Average Balance                         | Yield  |      | Average Balance | Yield       | Interest Income |
| Loans receivable, net of deferred fees   | \$444,989                               | 9.11 % |      | \$530,493       | 8.20 %      | \$(2,218 )      |
| Loans held for sale                      | --                                      | --     |      | 814             | 4.13        | (17 )           |
| Interest bearing deposits in other banks | 100,524                                 | 0.24   |      | 194,002         | 0.25        | (188 )          |
| Investments, available-for-sale          | 426,521                                 | 2.08   |      | 423,143         | 2.15        | (160 )          |
| FHLB stock                               | 17,713                                  | --     |      | 17,717          | --          | --              |
| Total interest-earning assets            | \$989,747                               | 5.02 % |      | \$1,166,169     | 4.55 %      | \$(2,583 )      |

The average yield on loans increased due to accretion of discounts on purchased loans in the LibertyBank Acquisition. There was no income on loans held for sale during the nine months ended September 30, 2012, as we ceased originating mortgage loans for sale in the secondary market in January 2012.

Interest Expense. Managed reduction in certificates of deposits combined with lower average interest-bearing core deposits resulted in a reduced cost of funds during the nine months ended September 30, 2012, compared to the nine months ended September 30, 2011. Additionally, the Bank paid off all outstanding borrowings with the FHLB in September 2011, which reduced interest expense on borrowings during the nine months ended September 30, 2012, compared to the same period in 2011. The cost of funds on interest-bearing liabilities for the nine months ended September 30, 2012 was 0.54% compared to 0.86% for the nine months ended September 30, 2011. The following table details average balances, cost of funds and the change in interest expense (dollars in thousands):

|                                    | For the Nine Months Ended September 30, |        |      |                 |             |                  |
|------------------------------------|---|--------|------|-----------------|-------------|------------------|
|                                    | 2012                                    |        | 2011 |                 | Decrease in |                  |
|                                    | Average Balance                         | Rate   |      | Average Balance | Rate        | Interest Expense |
| Savings deposits                   | \$80,817                                | 0.08 % |      | \$79,979        | 0.18 %      | \$(61 )          |
| Interest-bearing demand deposits   | 245,048                                 | 0.18   |      | 238,503         | 0.28        | (182 )           |
| Money market deposits              | 179,244                                 | 0.21   |      | 176,475         | 0.39        | (232 )           |
| Certificates of deposit            | 241,412                                 | 1.28   |      | 407,171         | 1.11        | (1,066 )         |
| FHLB advances and other borrowings | 4,751                                   | 1.52   |      | 53,075          | 4.05        | (1,559 )         |
| Total interest-bearing liabilities | \$751,272                               | 0.54 % |      | \$955,203       | 0.86 %      | \$(3,100 )       |

The decline in average certificates of deposits during the nine months ended September 30, 2012 compared to the nine months ended September 30, 2011, was due to maturities of certificates of deposit primarily in the LibertyBank Acquisition deposit portfolio. Due to the significant amount of cash we received in the LibertyBank Acquisition, the low interest rate environment, and weak loan demand from creditworthy borrowers, we reduced our rates on deposits during 2011 and 2012, permitting certificates of deposit to decline. As noted earlier, we repaid all outstanding advances from the FHLB during the fiscal year ended September 30, 2011. At September 30, 2012, borrowings consisted of retail repurchase agreements.

Provision for Loan Losses. A negative provision for loan losses of (\$1.1 million) was recorded during the nine months ended September 30, 2012, compared to a provision of \$8.4 million for the same year-ago period. The negative provision related to covered loans purchased in the CFB Acquisition was primarily due to some large recoveries realized during the first nine months of the year, which necessitated a negative provision of (\$1.9 million). This negative provision was partially offset, however, by a provision for loan losses on certain pools of loans purchased in the LibertyBank Acquisition totaling \$822,000 during the nine months ended September 30, 2012. Net of amounts recorded in noninterest income as FDIC indemnification recovery/(provision), the impact of the provision for loan losses decreased income before taxes by \$68,000 and \$1.1 million during the nine months ended September 30, 2012, and 2011, respectively.

The following table details the impact of the provision for loan losses and the FDIC indemnification recovery on income before taxes for the nine months ended September 30, 2012 and 2011 (in thousands):

|  | For the Nine Months Ended<br>September 30, |          |
|--|--|----------|
|  | 2012                                       | 2011     |
| Provision for loan losses on:  |  |          |
| Noncovered originated loans  | \$ --                                      | \$ 222   |
| Covered loans – CFB Acquisition  | (1,934 )                                   | 5,220    |
| Covered loans – LibertyBank Acquisition  | 822  | 2,954    |
| Total gross provision for loan losses  | (1,112 )                                   | 8,396    |
| Less: FDIC indemnification recovery/(provision) reported<br>in noninterest income: |  |          |
| Noncovered originated loans  | --   | --       |
| Covered loans – CFB Acquisition  | (1,837 )                                   | 4,959    |
| Covered loans – LibertyBank Acquisition  | 657  | 2,358    |
| Total FDIC indemnification recovery/(provision)                                    | (1,180 )                                   | 7,317    |
| Net decrease (increase) to income before taxes:                                    |  |          |
| Noncovered originated loans  | --   | 222      |
| Covered loans – CFB Acquisition  | (97 )                                      | 261      |
| Covered loans – LibertyBank Acquisition  | 165  | 596--    |
| Net decrease in income before income taxes   | \$ 68                                      | \$ 1,079 |

Noninterest Income. Noninterest income for the nine months ended September 30, 2012, was a negative (\$322,000), compared to \$8.8 million of noninterest income during the same period in the previous year. The significantly reduced amount in the current year was primarily due to the impairment of the FDIC indemnification asset, and the impact of the indemnification recovery related to the negative provision for loan losses, which totaled \$8.0 million and \$1.1 million, respectively, during the first nine months of 2012. The following table provides a detailed analysis of the changes in components of noninterest income (dollars in thousands):

|  | Nine Months Ended<br>September 30, |          | Increase/(Decrease) |           |
|--|------------------------------------|----------|---------------------|-----------|
|  | 2012                               | 2011     | Amount              | Percent   |
| Service charges and fees                             | \$6,491                            | \$7,363  | \$(872 )            | (11.8 )%  |
| Gain on sale of loans                                | 1                                  | 501      | (500 )              | (99.8 )   |
| Gain on sale of investments available-for-sale       | 1,217                              | 607      | 610                 | 100.5     |
| Gain on sale of fixed assets and repossessed assets  | 554                                | 205      | 349                 | 170.2     |
| FDIC indemnification (recovery)                      | (1,180 )                           | 7,317    | (8,497 )            | (116.1 )  |
| Accretion (impairment) of FDIC indemnification asset | (8,042 )                           | (5,911 ) | (2,131 )            | (36.1 )   |
| Prepayment penalty on borrowings                     | --                                 | (2,007 ) | 2,007               | 100.0     |
| Other  | 637                                | 667      | (30 )               | (4.5 )    |
| Total noninterest income                             | \$(322 )                           | \$8,742  | \$(9,064 )          | (103.7 )% |

The following table presents noninterest income excluding the impact of FDIC indemnification items on all covered loans (in thousands):

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|  | Nine Months Ended<br>September 30, |          |
|--|------------------------------------|----------|
|  | 2012                               | 2011     |
| Total noninterest income, as reported                          | \$ (322 )                          | \$ 8,742 |
| Less: FDIC indemnification recovery                            | (1,180 )                           | 7,317    |
| Accretion (impairment) of FDIC indemnification asset           | (8,042 )                           | (5,911 ) |
| Total noninterest income, excluding FDIC indemnification items | \$ 8,900                           | \$ 7,336 |

The impairment of the FDIC indemnification asset was higher in 2012 due to higher expected cash flows in loan pools purchased in the LibertyBank Acquisition. As noted earlier, increases in estimated cash flows increase interest on loans through higher accretable yield on purchased loans.

Service charges and fee income decreased \$872,000 to \$6.5 million for the nine months ended September 30, 2012, compared to \$7.4 million in the same period a year ago. Compared to the year-ago nine month period, overdraft fees were \$921,000 lower in the nine months ended September 30, 2012 due to fewer “free checking” accounts and regulatory changes that were first implemented in July 2010. Losses on checking accounts declined \$75,000 to \$102,000 during the nine months ended September 30, 2012.

Noninterest income includes pre-tax gains on sales of investments of \$1.2 million during the nine months ended September 30, 2012, compared to \$607,000 for the nine months ended September 30, 2011. Most of the gains during 2012 were realized on U.S. Treasury bonds that were purchased during the first half of 2012 and the sales were executed as a result of the strong rally in the bond market subsequently in 2012. The \$607,000 gain during the September 2011 quarter was related to the sale of mortgage-backed securities.

The gain on sale of fixed assets and REO was \$554,000 and \$205,000 during the nine months ended September 30, 2012 and 2011, respectively.

Noninterest Expense. Noninterest expense for the nine months ended September 30, 2012, decreased \$7.1 million or 18.0% to \$32.6 million compared to \$39.7 million for the nine months ended September 30, 2011, due to a significant reduction in personnel and integration costs as a result of the consolidation of operating systems of the acquired operations of LibertyBank and Community First Bank that was completed during the later part of the first half of fiscal year 2011 and branch closures that occurred during the fourth quarter of 2011.

The following table provides a detailed analysis of the changes in components of noninterest expense (dollars in thousands):

|                             | Nine Months Ended<br>September 30, |           | Decrease    |          |
|-----------------------------|------------------------------------|-----------|-------------|----------|
|                             | 2012                               | 2011      | Amount      | Percent  |
| Compensation and benefits   | \$ 18,029                          | \$ 21,042 | \$ (3,013 ) | (14.3 )% |
| Occupancy and equipment     | 4,543                              | 5,051     | (508 )      | (10.1 )  |
| Data processing             | 2,867                              | 3,066     | (199 )      | (6.5 )   |
| Advertising                 | 596                                | 909       | (313 )      | (34.4 )  |
| Postage and supplies        | 763                                | 998       | (235 )      | (23.5 )  |
| Professional services       | 1,947                              | 2,486     | (539 )      | (21.7 )  |
| Insurance and taxes         | 1,585                              | 2,244     | (659 )      | (29.4 )  |
| Amortization of intangibles | 433                                | 530       | (97 )       | (18.3 )  |
| Provision for REO           | 454                                | 739       | (285 )      | (38.6 )  |
| Other                       | 1,335                              | 2,626     | (1,291 )    | (49.2 )  |
| Total noninterest expense   | \$ 32,552                          | \$ 39,691 | \$ (7,139 ) | (18.0 )% |

Compensation and benefits expense decreased \$3.0 million during the nine months ended September 30, 2012, compared to the same year ago period due to branch closings and the consolidation of operations that occurred during calendar year 2011. Compensation expense related to the KSOP was \$596,000 during the nine months ended September 30, 2012, compared to \$1.2 million in the year ago period for ESOP and 401(k) expense. The reduced expense in 2012 was a result of the merger of the ESOP and the 401(k) plan.

All other categories of expenses were \$4.1 million in the aggregate lower during the nine months ended September 30, 2012 compared to the same period a year ago. Occupancy and equipment expense was \$508,000 lower in 2012 due to branch closures that occurred in late 2011. Professional services declined by \$539,000 in 2012 compared to 2011 as a result of a number of information technology integration projects that were in process in the first half of 2011 that have since been completed. Insurance and taxes declined by \$659,000 in 2012 primarily due to a change in the assessment base for deposit insurance premiums, as well as lower REO balances and fewer branches in 2012 and

the timing of accruals for property taxes. Other operating expenses were \$1.3 million lower, primarily due to \$1.1 million of expenses incurred in September 2011 related to branch closures.

#### Liquidity, Commitments and Capital Resources

**Liquidity.** We actively analyze and manage liquidity with the objectives of maintaining an adequate level of liquidity and to ensure the availability of sufficient cash flows to support loan growth, fund deposit withdrawals, fund operations and satisfy other financial commitments. See the “Consolidated Statements of Cash Flows” contained in Item 1 - Financial Statements, included herein.

The primary sources of funds are customer deposits, loan repayments, sales and maturities of investments and, to a lesser extent, FHLB borrowings. These sources of funds are used to make loans, purchase investments and fund continuing operations. While maturities and the scheduled amortization of loans are generally predictable sources of funds, deposit flows and loan prepayments are greatly influenced by the level of interest rates, economic conditions and competition. The Company’s liquidity ratio (defined as the sum of cash and cash equivalents and investments available-for-sale divided by total assets) was 50.1% at September 30, 2012, compared to 48.7% at December 31, 2011. This high level of liquidity is primarily attributable to the LibertyBank Acquisition, as the Company received \$313.9 million from the FDIC in connection with this acquisition and assumed \$59.2 million of cash held by LibertyBank on the acquisition date. Funds obtained from the LibertyBank Acquisition have been invested primarily in investments since the acquisition date. We will continue to invest excess cash in medium-term investments, but will also conserve some cash in order to meet the demand of maturing certificates of deposit, prepare for the potential of rising interest rates, and to provide flexibility for potential acquisitions or repurchases of common stock.

At September 30, 2012, certificates of deposit totaled \$217.0 million, or 25.3% of total deposits, including \$113.0 million that are scheduled to mature within the next twelve months from September 30, 2012. We believe our current liquidity position and anticipated operating results are sufficient to fund known, existing commitments and activity levels.

At September 30, 2012, the Bank maintained a borrowing facility with the FHLB of Seattle equal to 40% of total assets to the extent the Bank provides qualifying collateral and holds sufficient FHLB stock. At September 30, 2012, the Bank was in compliance with the collateral requirements and \$101.9 million of the line of credit was available. Despite the fact no borrowings were outstanding September 30, 2012, the Bank from time to time can be highly dependent on the FHLB of Seattle to provide the primary source of wholesale funding for immediate liquidity and borrowing needs. The failure of the FHLB of Seattle or the FHLB system in general, may materially impair the Company’s ability to meet our growth plans or to meet short and long-term liquidity demands.

**Off-Balance Sheet Arrangements.** The Bank is party to financial instruments with off-balance sheet risk in the normal course of business in order to meet the financing needs of the Bank’s customers. These financial instruments generally include commitments to originate mortgage, commercial and consumer loans, and involve to varying degrees, elements of credit and interest rate risk in excess of amounts recognized in the Consolidated Balance Sheets. The Bank’s maximum exposure to credit loss in the event of nonperformance by the borrower is represented by the contractual amount of those instruments. Because some commitments may expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The same credit policies are used in making commitments as are used for on-balance sheet instruments. Collateral is required in instances where deemed necessary.

Undisbursed balances of loans closed include funds not disbursed but committed for construction projects. Unused lines of credit include funds not disbursed, but committed, for home equity, commercial and consumer lines of credit.



Commercial letters of credit are conditional commitments issued to guarantee the performance of a customer to a third party. Those guarantees are primarily used to support public and private borrowing arrangements. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers.

In connection with certain asset sales, the Bank typically makes representations and warranties about the underlying assets conforming to specified guidelines. If the underlying assets do not conform to the specifications, the Bank may have an obligation to repurchase the assets or indemnify the purchaser against loss. These representations and warranties are most applicable to the residential mortgages sold in the secondary market. The Bank believes that the potential for significant loss under these arrangements is remote. However, past performance may not be representative of future performance on sold loans and the Bank may experience material losses in the future.

The following is a summary of commitments and contingent liabilities with off-balance sheet risks as of September 30, 2012 (in thousands):

|                                     | Contract or<br>Notional<br>Amount |
|-------------------------------------|-----------------------------------|
| Commitments to extend credit:       |                                   |
| Fixed rate                          | \$ 17,805                         |
| Adjustable rate                     | 2,575                             |
| Undisbursed balance of loans closed | 15,871                            |
| Unused lines of credit              | 68,877                            |
| Commercial letters of credit        | 1,882                             |
| Total                               | \$ 107,010                        |

Capital. Consistent with the Bank's goal to operate a sound and profitable financial organization, efforts are ongoing to actively seek to maintain a "well capitalized" institution in accordance with regulatory standards. The Company's consolidated capital ratios at September 30, 2012, were as follows: Tier 1 capital 15.42%; Tier 1 (core) risk-based capital 37.34%; and total risk-based capital 38.61%. The applicable regulatory capital requirements to be considered well capitalized are 5%, 6% and 10%, respectively. The Bank's regulatory capital ratios at September 30, 2012, were as follows: Tier 1 capital 13.49%; Tier 1 (core) risk-based capital 32.39%; and total risk-based capital 33.66%. As of September 30, 2012, the Bank exceeded all regulatory capital requirements and had a consolidated tangible capital ratio of 14.85%.

### Cyber Risks

As a financial institution that serves over 100,000 clients through 28 branches the Internet and other distribution channels, we depend on our ability, and the abilities of several third party vendors, to process, record and monitor a large number of customer transactions on a continuous basis. As our customer base and locations have expanded through acquisition and organic growth, and as customer, public and regulatory expectations regarding operational and information security have increased, our operational systems and infrastructure have been, and must continue to be, safeguarded and monitored for potential failures, disruptions and breakdowns. Our business, financial, accounting, data processing systems or other operating systems and facilities may stop operating properly or become disabled or damaged as a result of a number of factors including events that are wholly or partially beyond our control. For example, there could be sudden increases in customer transaction volume; electrical or telecommunications outages; natural disasters such as earthquakes, tornados, and hurricanes; disease pandemics; events arising from local or larger scale political or social matters, including terrorist acts; and, as described below, cyber attacks. Although we have business continuity plans and other safeguards in place, our business operations may be adversely affected by significant and widespread disruption to our physical infrastructure or operating systems that support our businesses and customers.

Information security risks for financial institutions such as Home Federal Bank have generally increased in recent years in part because of the proliferation of new technologies, the use of the Internet and telecommunications technologies to conduct financial transactions, and the increased sophistication and activities of organized crime, hackers, terrorists, activists, and other external parties. Those parties also may attempt to fraudulently induce employees, customers, or other users of our systems to disclose confidential information in order to gain access to our data or that of our customers. As noted above, our operations rely on the secure processing, transmission and storage of confidential information in our computer systems and networks. Our retail and commercial banking services businesses rely on our digital technologies, computer and email systems, software, and networks to conduct their operations. In addition, to access our products and services, our customers may use personal smart phones,

tablets, and other mobile devices that are beyond our control systems. Although we believe we have effective information security procedures and controls, our technologies, systems, networks, and our customers' devices may become the target of cyber attacks or information security breaches that could result in the unauthorized release, gathering, monitoring, misuse, loss or destruction of Home Federal Bank's or our customers' confidential, proprietary and other information, or otherwise disrupt our business operations. We have purchased property and cyber insurance to mitigate the financial impact of such events; however, losses could exceed our coverage limits and the impact to our reputation as a result of a material breach could significantly impair our ability to maintain client relationships and conduct business.

Third parties with which we do business or that facilitate our business activities, including exchanges, clearing houses, financial intermediaries or vendors that provide services or security solutions for our operations, could also be sources of operational and information security risk to us, including from breakdowns or failures of their own systems or capacity constraints. Poor security controls utilized by merchants and merchant processors also expose us to risk of loss that is beyond our control.

Although to date we have not experienced any material losses relating to cyber attacks or other information security breaches, there can be no assurance that we will not suffer such losses in the future. Our risk and exposure to these matters remains heightened because of, among other things, the evolving nature of these threats, our role in the financial services industry, our plans to continue to implement our Internet banking and mobile banking channel strategies and develop additional remote connectivity solutions to serve our clients when and how they want to be served, the outsourcing of some of our business operations, and the continued uncertain economic environment. As a result, cyber security and the continued development and enhancement of our controls, processes and practices designed to protect our systems, computers, software, data and networks from attack, damage or unauthorized access remain a priority for Home Federal Bank. As cyber threats continue to evolve, we may be required to expend significant additional resources to continue to modify or enhance our protective measures or to investigate and remediate any information security vulnerabilities.

Disruptions or failures in the physical infrastructure or operating systems that support our businesses and customers, or cyber attacks or security breaches of the networks, systems or devices that our customers use to access our products and services could result in customer attrition, financial losses, the inability of our customers to transact business with us, violations of applicable privacy and other laws, regulatory fines, penalties or intervention, reputational damage, reimbursement or other compensation costs, and/or additional compliance costs, any of which could materially adversely affect our results of operations or financial condition.

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

The Company's Board of Directors has established an asset and liability management policy to guide management in maximizing net interest spread by managing the differences in terms between interest-earning assets and interest-bearing liabilities while maintaining acceptable levels of liquidity, capital adequacy, interest rate sensitivity, credit risk and profitability. The Asset/Liability Management Committee, consisting of certain members of senior management, communicate, coordinate and manage asset/liability positions consistent with the business plan and Board-approved policies, as well as to price savings and lending products, and to develop new products.

One of the Bank's primary financial objectives is to generate ongoing profitability. The Bank's profitability depends primarily on its net interest income, which is the difference between the income it receives on its loan and investment portfolio and its cost of funds, which consists of interest paid on deposits and borrowings. The rates the Company earns on assets and pays on liabilities generally are established contractually for a period of time. Market interest rates change over time. The Bank's loans generally have longer maturities than its deposits. Accordingly, the Company's results of operations, like those of other financial institutions, are affected by changes in interest rates and the interest rate sensitivity of assets and liabilities. The Bank measures its interest rate sensitivity on a quarterly basis using an

internal model.

In recent years, the Company has primarily utilized the following strategies in its efforts to manage interest rate risk:

- § Reduced our reliance on long-term, fixed-rate one-to-four family residential loans by originating nearly all of these loans for sale in the secondary market or through referrals to third party origination brokers and subsequently ceasing originations of these loans in December 2011;
- § Increased originations of adjustable-rate commercial and commercial real estate loans;
- § Acquisitions of banking operations with a higher mix of commercial loans than our organic portfolio; and,
- § Reduced our reliance on higher-rate certificates of deposit and FHLB borrowings by focusing on core deposit growth, including checking and savings accounts that are less-sensitive to interest rate changes and have longer average lives than certificates of deposit.

At September 30, 2012, the Company had no off-balance sheet derivative financial instruments, and the Bank did not maintain a trading account for any class of financial instruments or engage in hedging activities or purchase high risk derivative instruments. Furthermore, the Company is not subject to foreign currency exchange rate risk or commodity price risk.

There has not been any material change in the market risk disclosures contained in the Company's 2011 Form 10-K.

#### Item 4. Controls and Procedures

##### (a) Evaluation of Disclosure Controls and Procedures.

An evaluation of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) of the Securities Exchange Act of 1934 (the "Exchange Act")) was carried out under the supervision and with the participation of the Company's Chief Executive Officer, Chief Financial Officer, and other members of the Company's management team as of the end of the period covered by this report. The Company's Chief Executive Officer and Chief Financial Officer concluded that as of September 30, 2012, the Company's disclosure controls and procedures were effective in ensuring that the information required to be disclosed by the Company in the reports it files or submits under the Act is (i) accumulated and communicated to the Company's management (including the Chief Executive Officer and Chief Financial Officer) in a timely manner, and (ii) recorded, processed, summarized, and reported within the time periods specified in the Securities and Exchange Commission's rules and forms.

##### (b) Changes in Internal Controls.

There have been no changes in the Company's internal control over financial reporting (as defined in 13a-15(f) of the Exchange Act) that occurred during the quarter ended September 30, 2012, that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting. A number of internal control procedures were, however, modified during the quarter in conjunction with the Bank's internal control testing, ongoing operational changes and the integration of the application systems of acquired businesses. These controls also relate to the accounting and reporting for acquired loans, which is highly subjective and requires significant estimation of future events. The Company also continued to implement control enhancements to remediate findings and deficiencies identified by its internal auditor and independent registered public accounting firm.

The Company intends to continually review and evaluate the design and effectiveness of its disclosure controls and procedures and to improve its controls and procedures over time and to correct any deficiencies that it may discover in the future. The goal is to ensure that senior management has timely access to all material financial and non-financial information concerning the Company's business. While the Company believes the present design of its disclosure controls and procedures is effective to achieve its goal, future events affecting its business may cause the Company to modify its disclosure controls and procedures. The Company does not expect that its disclosure controls and procedures and internal control over financial reporting will prevent every error or instance of fraud. A control procedure, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control procedure are met. Because of the inherent limitations in all control procedures, no evaluation

of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns in controls or procedures 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 control procedure is 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 become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control procedure, misstatements due to error or fraud may occur and not be detected.

## PART II - OTHER INFORMATION

### Item 1. Legal Proceedings

The Company reported on its Form 10-Q for the quarter ended June 30, 2010 that on June 25, 2010, a borrower of the Bank filed a Complaint and Demand for Jury Trial in Canyon County, Idaho, asserting a claim against the Bank for alleged breach of contract, breach of the covenant of good faith and fair dealing and violation of the Uniform Commercial Code in connection with a borrowing agreement between the borrower and the Bank. No specific dollar amount of damages was specified in the complaint, however, the borrower is seeking an award of damages sufficient to compensate the borrower for the foreseeable damages caused by the Bank's alleged breaches as described above, including, but not limited to, lost profits, business devastation damages, the loss of goodwill and reputation in the business community and injury to its credit standing. The Bank believes the claims are without merit and has vigorously defended against these claims. The case is scheduled to go to a jury trial beginning in November 2012. In the opinion of management, based on currently available information, the resolution of this legal action is not expected to have a material adverse effect on the Company's financial position or results of operations.

### Item 1A. Risk Factors

There have been no material changes in the risk factors previously disclosed in Item 1A of the Company's 2011 Form 10-K.

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

(a) Not applicable.

(b) Not applicable.

(c) The following table provides information about repurchases of common stock made by the Company during the quarter ended September 30, 2012:

| Period of Repurchase             | Total<br>Number<br>of Shares<br>Purchased | Average<br>Price<br>Paid Per<br>Share | Total<br>Number of<br>Shares<br>Purchased<br>as Part of<br>Publicly<br>Announced<br>Plans or<br>Programs | Maximum<br>Number<br>of Shares<br>that May<br>Yet Be<br>Purchased<br>Under the<br>Program |
|----------------------------------|---|---------------------------------------|--|---|
| July 1 – July 31, 2012           | 46,550                                    | \$ 10.01                              | 46,550   | 697,570   |
| August 1 – August 31, 2012       | 206,403                                   | 10.04                                 | 206,403  | 491,167   |
| September 1 – September 30, 2012 | 468,291                                   | 10.29                                 | 468,291  | 22,876  |



Item 3. Defaults Upon Senior Securities

Not applicable.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

Not applicable.

Item 6. Exhibits

- 2.1 Purchase and Assumption Agreement for Community First Bank Transaction (1)
- 2.2 Purchase and Assumption Agreement for LibertyBank Transaction (2)
- 3.1 Articles of Incorporation of the Registrant (3)
- 3.2 Amended and Restated Bylaws of the Registrant (4)
- 10.1 Amended Employment Agreement entered into by Home Federal Bancorp, Inc. with Len E. Williams (5)
- 10.2 Amended Severance Agreement with Eric S. Nadeau (5)
- 10.3 Amended Severance Agreement with R. Shane Correa (5)
- 10.4 Amended Severance Agreement with Cindy L. Bateman (5)
- 10.5 Form of Home Federal Bank Employee Severance Compensation Plan (6)
- 10.6 Form of Director Indexed Retirement Agreement entered into by Home Federal Savings and Loan Association of Nampa with each of its Directors (3)
- 10.7 Form of Director Deferred Incentive Agreement entered into by Home Federal Savings and Loan Association of Nampa with each of its Directors (3)
- 10.8 Form of Executive Deferred Incentive Agreement, and amendment thereto, entered into by Home Federal Savings and Loan Association of Nampa with Daniel L. Stevens, Robert A. Schoelkoph, and Lynn A. Sander (3)
- 10.9 Form of Amended and Restated Salary Continuation Agreement entered into by Home Federal Savings and Loan Association of Nampa with Daniel L. Stevens (3)
- 10.10 Amended and Restated Salary Continuation Agreement entered into by Home Federal Bank with Len E. Williams (5)
- 10.11 Amended and Restated Salary Continuation Agreement entered into by Home Federal Bank with Eric S. Nadeau (5)
- 10.12 Amended and Restated Salary Continuation Agreement entered into by Home Federal Bank with R. Shane Correa (7)
- 10.13 2005 Stock Option and Incentive Plan approved by stockholders on June 23, 2005 and Form of Incentive Stock Option Agreement and Non-Qualified Stock Option Agreement (8)
- 10.14 2005 Recognition and Retention Plan approved by stockholders on June 23, 2005 and Form of Award Agreement (8)
- 10.15 Director Retirement Plan entered into by Home Federal Bank with each of its Independent Directors (9)
- 10.16 Transition Agreement with Daniel L. Stevens (10)
- 10.17 2008 Equity Incentive Plan (11)
- 31.1 Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act \*
- 31.2 Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act \*
- 32 Certification Pursuant to Section 906 of the Sarbanes-Oxley Act \*
- 101 The following materials from the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2012, formatted in Extensible Business Reporting Language (XBRL): (1) Consolidated Balance Sheets; (2) Consolidated Statements of Operations; (3) Consolidated Statements of Comprehensive Income (Loss); (4) Consolidated Statements of Stockholders' Equity; (5) Consolidated Statements of Cash Flows; and (6) Selected Notes to Consolidated Financial Statements. (12)

(1) Filed as an exhibit to the Registrant's Current Report on Form 8-K dated August 7, 2009

(2) Filed as an exhibit to the Registrant's Current Report on Form 8-K dated July 30, 2010

(3) Filed as an exhibit to the Registrant's Registration Statement on Form S-1 (333-146289) dated September 25, 2007

(4) Filed as an exhibit to the Registrant's Registration Statement on Form 8-K dated April 2, 2012

(5) Filed as an exhibit to the Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2011

(6) Filed as an exhibit to the Registrant's Quarterly Report on Form 10-Q for the quarter ended December 31, 2008

(7) Filed as an exhibit to the Registrant's Annual Report on Form 10-K for the year ended September 30, 2011

(8) Filed as an exhibit to the Registrant's Registration Statement on Form S-8 (333-127858)

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- (9) Filed as an exhibit to the Registrant's Current Report on Form 8-K dated October 21, 2005
- (10) Filed as an exhibit to the Registrant's Current Report on Form 8-K dated August 21, 2006
- (11) Filed as an exhibit to the Registrant's Registration Statement on Form S-8 (333-157540)
- (12) Pursuant to Rule 406T of Regulation S-T, these interactive data files are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933 or Section 18 of the Securities Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.

\* Filed herewith

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.

Home Federal Bancorp, Inc.

Date: November 8, 2012

/s/ Len E. Williams  
Len E. Williams  
President and  
Chief Executive Officer  
(Principal Executive Officer)

Date: November 8, 2012

/s/ Eric S. Nadeau  
Eric S. Nadeau  
Executive Vice President and  
Chief Financial Officer  
(Principal Financial and Accounting Officer)

EXHIBIT INDEX

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\*Pursuant to Rule 406T of Regulation S-T, these interactive data files are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933 or Section 18 of the Securities Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.