EVANS BANCORP INC
Form 10-K
March 04, 2013
UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

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

For the fiscal year ended: December 31, 2012

[ ] 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: 001-35021

EVANS BANCORP, INC.

(Exact name of registrant as specified in its charter)

New York	16-1332767
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

14-16 North Main Street, Angola, New York	14006
(Address of principal executive offices)	(Zip Code)

(716) 926-2000
Registrant’s telephone number (including area code)

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	Name of Each Exchange on Which Registered
Common Stock, Par Value $.50 per share	NYSE MKT LLC

Securities registered pursuant to Section 12(g) of the Act:

None
(Title of Class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes No X

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.

Yes No X

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

Yes X No

Indicate by checkmark 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 during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes X No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. [X]

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

Large accelerated filer	Accelerated filer
Non-accelerated filer (do not check if a smaller reporting company)	Smaller reporting company X

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

Yes No X

On June 30, 2012, the aggregate market value of the registrant's common stock held by non-affiliates was approximately $48.8 million, based upon the closing sale price of a share of the registrant's common stock on the NYSE MKT LLC.

As of March 1, 2013, 4,171,473 shares of the registrant's common stock were outstanding.

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DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's Proxy Statement relating to the registrant's 2013 Annual Meeting of Shareholders, to be held on April 25, 2013, which will be subsequently filed with the Securities and Exchange Commission within 120 days after the end of the fiscal year to which this Report relates, are incorporated by reference into Part III of this Annual Report on Form 10-K where indicated.

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PART I

FORWARD LOOKING STATEMENTS

This Annual Report on Form 10-K may contain certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended (the “Securities Act”), and Section 21E of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), that involve substantial risks and uncertainties. When used in this report, or in the documents incorporated by reference herein, the words “anticipate,” “believe,” “estimate,” “expect,” “intend,” “may,” “plan “seek,” “goal,” and similar expressions identify such forward-looking statements. These forward-looking statements include statements regarding the business plans, prospects, growth and operating strategies of Evans Bancorp, Inc. (the “Company"), statements regarding the asset quality of the Company’s loan and investment portfolios, and estimates of the Company’s risks and future costs and benefits.

These forward-looking statements are based largely on the expectations of the Company’s management and are subject to a number of risks and uncertainties, including but not limited to: general economic conditions, either nationally or in the Company’s market areas, that are worse than expected; increased competition among depository or other financial institutions; inflation and changes in the interest rate environment that reduce the Company’s margins or reduce the fair value of financial instruments; changes in laws or government regulations affecting financial institutions, including changes in regulatory fees and capital requirements; the Company’s ability to enter new markets successfully and capitalize on growth opportunities; the Company’s ability to successfully integrate acquired entities; changes in accounting pronouncements and practices, as adopted by financial institution regulatory agencies, the Financial Accounting Standards Board (“FASB”) and the Public Company Accounting Oversight Board; changes in consumer spending, borrowing and saving habits; changes in the Company’s organization, compensation and benefit plans; and other factors discussed elsewhere in this Annual Report on Form 10-K including the risk factors described in Item 1A, as well as in the Company’s periodic reports filed with the Securities and Exchange Commission (the “SEC”). Many of these factors are beyond the Company’s control and are difficult to predict.

Because of these and other uncertainties, the Company’s actual results, performance or achievements could differ materially from those contemplated, expressed or implied by the forward-looking statements contained herein. Forward-looking statements speak only as of the date they are made. The Company undertakes no obligation to publicly update or revise forward-looking information, whether as a result of new, updated information, future events or otherwise.

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Item 1. BUSINESS

EVANS BANCORP, INC.

Evans Bancorp, Inc. (the "Company") is a New York business corporation which is registered as a financial holding company under the Bank Holding Company Act of 1956, as amended (the "BHCA"). The principal offices of the Company are located at 14-16 North Main Street, Angola, NY 14006 and its telephone number is (716) 926-2000. The Company's administrative office is located at One Grimsby Drive in Hamburg, NY. This facility is occupied by the Office of the President and Chief Executive Officer of the Company, as well as the Administrative and Loan Divisions of Evans Bank. The Company was incorporated on October 28, 1988, but the continuity of its banking business is traced to the organization of the Evans National Bank of Angola on January 20, 1920. Except as the context otherwise requires, the Company and its direct and indirect subsidiaries are collectively referred to in this report as the "Company." The Company's common stock is traded on the NYSE MKT under the symbol "EVBN."

At December 31, 2012, the Company had consolidated total assets of $809.7 million, deposits of $679.0 million and stockholders' equity of $74.8 million.

The Company's primary business is the operation of its subsidiaries. It does not engage in any other substantial business activities. The Company has two direct wholly-owned subsidiaries: (1) Evans Bank, N.A. ("Evans Bank" or the "Bank"), which provides a full range of banking services to consumer and commercial customers in Western New York; and (2) Evans National Financial Services, LLC ("ENFS"), which owns 100% of the membership interests in The Evans Agency, LLC ("TEA"), which sells various premium-based insurance policies on a commission basis. At December 31, 2012, the Bank represented 98.8% and ENFS represented 1.2% of the consolidated assets of the Company. Further discussion of our segments is included in Note 18 to the Company's Consolidated Financial Statements included under Item 8 of this Annual Report on Form 10-K.

Evans Bank

The Bank is a nationally chartered bank that has its headquarters at 14 North Main Street, Angola, NY, and a total of 13 full-service banking offices in Erie County and Chautauqua County, NY.

At December 31, 2012, the Bank had total assets of $799.6 million, investment securities of $95.8 million, net loans of $573.2 million, deposits of $683.4 million and stockholders' equity of $73.1 million, compared to total assets of $730.9

million, investment securities of $103.8 million, net loans of $571.9 million, deposits of $618.8 million and stockholders' equity of $68.4 million at December 31, 2011. The Bank offers deposit products, which include checking and NOW accounts, savings accounts, and certificates of deposit, as its principal source of funding. The Bank's deposits are insured up to the maximum permitted by the Bank Insurance Fund (the "Insurance Fund") of the Federal Deposit Insurance Corporation ("FDIC"). The Bank offers a variety of loan products to its customers, including commercial and consumer loans and commercial and residential mortgage loans.

As is the case with banking institutions generally, the Bank's operations are significantly influenced by general economic conditions and by related monetary and fiscal policies of banking regulatory agencies, including the Federal Reserve Board ("FRB") and FDIC. The Bank is also subject to the supervision, regulation and examination of the Office of the Comptroller of the Currency of the United States of America (the "OCC").

The Evans Agency, LLC

TEA, a property and casualty insurance agency, is a wholly-owned subsidiary of ENFS. TEA is headquartered in Angola, NY, with offices located throughout Western New York. TEA is a full-service insurance agency offering personal, commercial and financial services products. For the year ended December 31, 2012, TEA had total revenue of $7.0 million.

TEA's primary market area is Erie, Chautauqua, Cattaraugus and Niagara counties. Most lines of personal insurance are provided, including automobile, homeowners, boat, recreational vehicle, landlord, and umbrella coverage. Commercial insurance products are also provided, consisting of property, liability, automobile, inland marine, workers compensation, bonds, crop and umbrella insurance. TEA also provides the following financial services products: life and disability insurance, Medicare supplements, long term care, annuities, mutual funds, retirement programs and New York State Disability.

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Other Subsidiaries

In addition to the Bank and TEA, the Company has the following direct and indirect wholly-owned subsidiaries:

Evans National Leasing, Inc. (“ENL”). ENL, a wholly-owned subsidiary of the Bank, provided direct financing leasing of commercial small-ticket general business equipment to companies located throughout the contiguous 48 United States. The Company announced in April 2009 that it was exiting the leasing business. After attempting to sell the leasing portfolio, management decided to service it through to maturity, anticipated to be in approximately 2014.

Evans National Holding Corp. (“ENHC”). ENHC, a wholly-owned subsidiary of the Bank, operates as a real estate investment trust that holds commercial real estate loans and residential mortgages, providing additional flexibility and planning opportunities for the business of the Bank.

Suchak Data Systems, LLC (“SDS”). SDS, a wholly-owned subsidiary of the Bank, serves the data processing needs of financial institutions with customized solutions and consulting services. SDS hosts the Bank’s core and primary banking systems and provides product development and programming services. SDS’s products and services for its other customers include online banking systems, check imaging, item processing, and automated teller machine (“ATM”) services.

Evans National Financial Services, LLC (“ENFS”). ENFS is a wholly-owned subsidiary of the Company. ENFS's primary business is to own the business and assets of the Company’s non-banking financial services subsidiaries.

Frontier Claims Services, Inc. (“FCS”). FCS is a wholly-owned subsidiary of TEA and provides claims adjusting services to various insurance companies.

The Company also has two special purpose entities: Evans Capital Trust I, a statutory trust formed in September 2004 under the Delaware Statutory Trust Act, solely for the purpose of issuing and selling certain securities representing undivided beneficial interests in the assets of the trust, investing the proceeds thereof in certain debentures of the Company and engaging in those activities necessary, advisable or incidental thereto; and ENB Employers Insurance Trust, a Delaware trust company formed in February 2003 for the sole purpose of holding life insurance policies under the Bank’s bank-owned life insurance (“BOLI”) program.

The Company operates in two operating segments – banking activities and insurance agency activities. See Note 18 to the Company's Consolidated Financial Statements included under Item 8 of this Annual Report on Form 10-K for more information on the Company's operating segments.

MARKET AREA

The Company's primary market area is Erie County, Niagara County, northern Chautauqua County and northwestern Cattaraugus County, NY. This primary market area is the area where the Bank principally receives deposits and makes loans and TEA sells insurance. Even though ENL conducts business outside of this defined market area, this activity is not deemed to expand the Company's primary market.

MARKET RISK

For information about, and a discussion of, the Company's "Market Risk," see Part II, Item 7 "Management's Discussion and Analysis of Financial Condition and Results of Operations - Market Risk" of this Annual Report on Form 10-K.

COMPETITION

All phases of the Company's business are highly competitive. The Company competes actively with local, regional and national financial institutions, as well as with bank branches and insurance agency offices in the Company's primary market area of Erie County, Niagara County, northern Chautauqua County, and northwestern Cattaraugus County, NY. These Western New York counties have a high density of financial institutions, many of which are significantly larger and have greater financial resources than the Company. The Company faces competition for loans and deposits from other commercial banks, savings banks, internet banks, savings and loan associations, mortgage banking companies, credit unions, insurance companies and other financial services companies. The Company faces additional competition for deposits and insurance business from non-depository competitors such as the mutual fund industry, securities and brokerage firms, and insurance companies and brokerages. In the personal insurance area, the majority of TEA's competition comes from direct writers, as well as some small local agencies located in the same towns and villages in which TEA has offices. In the commercial business segment, the majority of the competition comes from larger

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agencies located in and around Buffalo, NY. By offering the large number of carriers which it has available to its customers, TEA has attempted to remain competitive in all aspects of its business.

As an approximate indication of the Company's competitive position, in Erie County, NY, where 13 of the Company's 14 banking offices are located, the Bank had the seventh most deposits according to the FDIC's annual deposit market share report as of June 30, 2012 with 2.0% of the total market's deposits of $29.8 billion. By comparison, the market leaders, M&T Bank and First Niagara Financial Group, have 69.8% of the county's deposits combined. The Company attempts to be generally competitive with all financial institutions in its service area with respect to interest rates paid on time and savings deposits, service charges on deposit accounts, and interest rates charged on loans.

SUPERVISION AND REGULATION

Bank holding companies and banks are extensively regulated under both federal and state laws and regulations that are intended to protect depositors and investors. Because the Company is a public company with shares traded on the NYSE MKT, it is subject to regulation by the Securities and Exchange Commission, as well as the listing standards required by NYSE MKT. To the extent that the following summary describes statutory and regulatory provisions, it is qualified in its entirety by reference to the particular statutory and regulatory provisions. Any change in the applicable law or regulation, or a change in the way such laws or regulations are interpreted by regulatory agencies or courts, may have a material adverse effect on the Company's business, financial condition and results of operations.

Bank Holding Company Regulation (BHCA)

As a financial holding company registered under the BHCA, the Company and its non-banking subsidiaries are subject to regulation and supervision under the BHCA by the FRB. The FRB requires periodic reports from the Company, and is authorized by the BHCA to make regular examinations of the Company and its subsidiaries. Under Regulation Y, a bank holding company must serve as a source of financial and managerial strength for its subsidiary banks and must not conduct its operations in an unsafe or unsound manner.

The Company is required to obtain the prior approval of the FRB before merging with or acquiring all or substantially all of the assets of, or direct or indirect ownership or control of more than 5% of the voting shares of, a bank or bank holding company. The FRB will not approve any acquisition, merger or consolidation that would have a substantial anti-competitive result, unless the anti-competitive effects of the proposed transaction are outweighed by a greater public interest in meeting the needs and convenience of the public.

The FRB also considers managerial, capital and other financial factors in acting on acquisition or merger applications. A bank holding company may not engage in, or acquire direct or indirect control of more than 5% of the voting shares of any company engaged in any non-banking activity, unless such activity has been determined by the FRB to be closely related to banking or managing banks. The FRB has identified by regulation various non-banking activities in which a bank holding company may engage with notice to, or prior approval by, the FRB.

The FRB has enforcement powers over financial holding companies and their subsidiaries, among other things, to interdict activities that represent unsafe or unsound practices or constitute violations of law, rule, regulation, administrative orders, or written agreements with a federal bank regulator. These powers may be exercised through the issuance of cease and desist orders, civil monetary penalties or other actions.

Bank holding companies and their subsidiary banks are also subject to the provisions of the Community Reinvestment Act ("CRA"). Under the terms of the CRA, the FRB (or other appropriate bank regulatory agency, in the case of the Bank, the OCC) is required, in connection with its examination of a bank, to assess such bank's record in meeting the credit needs of the communities served by that bank, including low and moderate-income neighborhoods. Furthermore, such assessment is taken into account in evaluating any application made by a bank holding company or a bank for, among other things, approval of a branch or other deposit facility, office relocation, a merger or an acquisition of bank shares.

Supervision and Regulation of Bank Subsidiaries

The Bank is a nationally chartered banking corporation subject to supervision, examination and regulation by the FRB, the FDIC and the OCC. These regulators have the power to enjoin "unsafe or unsound practices," require affirmative action to correct any conditions resulting from any violation or practice, issue an administrative order that can be judicially enforced, direct an increase in capital, restrict the growth of a bank, assess civil monetary penalties, and remove a bank's officers and directors.

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The operations of the Bank are subject to numerous statutes and regulations. Such statutes and regulations relate to required reserves against deposits, investments, loans, mergers and consolidations, issuance of securities, payment of dividends, establishment of branches, and other aspects of the Bank's operations. Various consumer laws and regulations also affect the operations of the Bank, including state usury laws, laws relating to fiduciaries, consumer credit and equal credit, fair credit reporting, and privacy of non-public financial information.

The Bank is subject to Sections 23A and 23B of the Federal Reserve Act and Regulation W there under, which govern certain transactions, such as loans, extensions of credit, investments and purchases of assets between member banks and their affiliates, including their parent holding companies. These restrictions limit the transfer from its subsidiaries, including the Bank, of funds to the Company in the form of loans, extensions of credit, investments or purchases of assets (collectively, "Transfers"), and they require that the Bank's transactions with the Company be on terms no less favorable to the Bank than comparable transactions between the Bank and unrelated third parties. Transfers by the Bank to any affiliate (including the Company) are limited in amount to 10% of the Bank's capital and surplus, and transfers to all affiliates are limited in the aggregate to 20% of the Bank's capital and surplus. Furthermore, such loans and extensions of credit are also subject to various collateral requirements. These regulations and restrictions may limit the Company's ability to obtain funds from the Bank for its cash needs, including funds for acquisitions, and the payment of dividends, interest and operating expenses.

The Bank is prohibited from engaging in certain tying arrangements in connection with any extension of credit, lease or sale of property or furnishing of services. For example, the Bank may not generally require a customer to obtain other services from the Bank or the Company, and may not require the customer to promise not to obtain other services from a competitor as a condition to an extension of credit. The Bank is also subject to certain restrictions imposed by the Federal Reserve Act on extensions of credit to executive officers, directors, principal stockholders or any related interest of such persons. Extensions of credit: (i) must be made on substantially the same terms (including interest rates and collateral) as those prevailing at the time for, and following credit underwriting procedures that are not less stringent than those applicable to, comparable transactions with persons not covered above and who are not employees, and (ii) must not involve more than the normal risk of repayment or present other unfavorable features. The Bank is also subject to certain lending limits and restrictions on overdrafts to such persons. A violation of these restrictions may result in the assessment of substantial civil monetary penalties on the Bank or any officer, director, employee, agent or other person participating in the conduct of the affairs of the Bank or the imposition of a cease and desist order.

As insurer, the FDIC imposes deposit insurance premiums and is authorized to conduct examinations of and to require reporting by, insured institutions. It may also prohibit an insured institution from engaging in any activity the FDIC determines by regulation or order to pose a serious threat to the FDIC. The FDIC also has the authority to initiate enforcement actions against insured institutions. The FDIC may terminate the deposit insurance of any insured depository institution, including the Bank, if it determines after a hearing that the institution has engaged or is engaging in unsafe or unsound practices, is in an unsafe or unsound condition to continue operations, or has violated any applicable law, regulation, order or any condition imposed by an agreement with the FDIC.

The FDIC has adopted a risk-based premium system that provides for quarterly assessments based on an insured institution's ranking in one of four risk categories based on their examination ratings and capital ratios. In addition, all FDIC-insured institutions are required to pay assessments to the FDIC to fund interest payments on bonds issued by the Financing Corporation (“FICO”), a mixed-ownership Federal government corporation established to recapitalize the Federal Savings and Loan Insurance Corporation. The current annualized assessment rate is 0.64 basis points, or approximately 0.16 basis points per quarter. These assessments will continue until the Financing Corporation bonds mature in 2019. Pursuant to the Dodd-Frank Act, the deposit insurance assessment base was redefined in 2011 to reflect consolidated total assets less average tangible equity. The result is that larger financial institutions, which have more assets leveraged with non-deposit wholesale funds, generally have paid a greater percentage of the aggregate insurance assessment and smaller banks, including the Bank, have paid less.

Regulations promulgated by the FDIC pursuant to the Federal Deposit Insurance Corporation Improvement Act of 1991 place limitations on the ability of certain insured depository institutions to accept, renew or rollover deposits by offering rates of interest which are significantly higher than the prevailing rates of interest on deposits offered by other depository institutions having the same type of charter in such depository institutions’ normal market area. Under these regulations, well-capitalized institutions may accept, renew or rollover such deposits without restriction, while adequately capitalized institutions may accept, renew or rollover such deposits with a waiver from the FDIC (subject to certain restrictions on payment of rates). Undercapitalized institutions may not accept, renew or rollover such deposits.

Under the Financial Institutions Reform, Recovery and Enforcement Act of 1989, a depository institution insured by the FDIC can be held liable for any loss incurred by, or reasonably expected to be incurred by, the FDIC in connection with: (i) the default of a commonly controlled FDIC-insured depository institution, or (ii) any assistance provided by the FDIC

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to a commonly controlled FDIC-insured institution in danger of default. "Default" is defined generally as the appointment of a conservator or receiver, and "in danger of default" is defined generally as the existence of certain conditions indicating that, in the opinion of the appropriate banking agency, a "default" is likely to occur in the absence of regulatory assistance.

In addition to the forgoing, federal regulators have adopted regulations and examination procedures promoting the safety and soundness of individual institutions by specifically addressing, among other things: (i) internal controls, information systems and internal audit systems; (ii) loan documentation; (iii) credit underwriting; (iv) interest rate exposure; (v) asset growth; (vi) ratio of classified assets to capital; (vii) minimum earnings; and (viii) compensation and benefits standards for management officials. Federal Reserve Board's regulations, for example, generally require a holding company to give the Federal Reserve Board prior notice of any redemption or repurchase of its own equity securities, if the consideration to be paid, together with the consideration paid for any repurchases or redemptions in the preceding year, is equal to 10% or more of the company's consolidated net worth. The Federal Reserve Board has broad authority to prohibit activities of bank holding companies and their non-banking subsidiaries which represent unsafe and unsound banking practices or which constitute violations of laws or regulations, and can assess civil money penalties for certain activities conducted on a knowing and reckless basis, if those activities caused a substantial loss to a depository institution.

Dividends paid by the Bank have been the Company's primary source of operating funds and are expected to be for the foreseeable future. Capital adequacy requirements serve to limit the amount of dividends that may be paid by the Bank. Under OCC regulations, the Bank may not pay a dividend, without prior OCC approval, if the total amount of all dividends declared during the calendar year, including the proposed dividend, exceed the sum of its retained net income to date during the calendar year and its retained net income over the preceding two years. As of December 31, 2012, approximately $10.6 million was available for the payment of dividends without prior OCC approval. The Bank's ability to pay dividends is also subject to the Bank being in compliance with regulatory capital requirements. As indicated below, at December 31, 2012, the Bank was in compliance with these requirements.

Because the Company is a legal entity separate and distinct from the Bank, the Company's right to participate in the distribution of assets of the Bank in the event of the Bank's liquidation or reorganization would be subject to the prior claims of the Bank's creditors. In the event of a liquidation or other resolution of an insured depository institution, the claims of depositors and other general or subordinated creditors are entitled to a priority of payment over the claims of unsecured, non-deposit creditors, including a parent bank holding company (such as the Company) or any shareholder or creditor thereof.

The FRB, the OCC and other federal banking agencies have broad enforcement powers, including the power to terminate deposit insurance, to impose substantial fines and other civil and criminal penalties, and to appoint a conservator or receiver for the assets of a regulated entity. Failure to comply with applicable laws, regulations and supervisory agreements could subject the Company or its subsidiaries, as well as officers, directors and other institution-affiliated parties of these organizations, to administrative sanctions and potential civil monetary penalties.

Capital Adequacy

The FRB, the FDIC and the OCC have adopted risk-based capital adequacy guidelines for bank holding companies and banks under their supervision. These capital adequacy guidelines are expected to be modified pursuant to the Basel III reform measures, described below. Under existing guidelines, the so-called "Tier 1 capital" and "Total capital" as a percentage of risk-weighted assets and certain off-balance sheet instruments must be at least 4% and 8%, respectively.

The FRB, the FDIC and the OCC have also imposed a leverage standard to supplement their risk-based ratios. This leverage standard focuses on a banking institution's ratio of Tier 1 capital to average total assets, adjusted for goodwill and certain other items. Under these guidelines, banking institutions that meet certain criteria, including excellent asset quality, high liquidity, low interest rate exposure and good earnings, and that have received the highest regulatory rating must maintain a ratio of Tier 1 capital to total adjusted average assets of at least 3%.

Institutions not meeting these criteria, as well as institutions with supervisory, financial or operational weaknesses, along with those experiencing or anticipating significant growth, are expected to maintain a Tier 1 capital to total adjusted average assets ratio equal to at least 4%. As reflected in the following table, the risk-based capital ratios and leverage ratios of the Company and the Bank as of December 31, 2012 and 2011 exceeded the required capital ratios for classification as "well capitalized," the highest classification under the regulatory capital guidelines.

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Capital Components and Ratios

(dollars in thousands)

	December 31, 2012 (dollars in thousands)							
	Company		Bank		Minimum for Capital Adequacy Purposes		Minimum to be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio	Amount	Ratio
Total Risk-Based Capital (to Risk Weighted Assets)	$ 84,843	14.7%	$ 80,251	13.9%	$ 46,287	8.0%	$ 57,859	10.0%
Tier I Capital (to Risk Weighted Assets)	$ 77,580	13.4%	$ 72,988	12.6%	$ 23,143	4.0%	$ 34,715	6.0%
Tier I Capital (to Average Assets)	$ 77,580	9.7%	$ 72,988	9.1%	$ 32,020	4.0%	$ 40,026	5.0%

	December 31, 2011 (dollars in thousands)							
	Company		Bank		Minimum for Capital Adequacy Purposes		Minimum to be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio	Amount	Ratio
Total Risk-Based Capital (to Risk Weighted Assets)	$ 78,173	14.0%	$ 75,050	13.5%	$ 44,575	8.0%	$ 55,719	10.0%
Tier I Capital (to Risk Weighted Assets)	$ 71,152	12.8%	$ 68,043	12.2%	$ 22,288	4.0%	$ 33,431	6.0%
Tier I Capital (to Average Assets)	$ 71,152	9.7%	$ 68,043	9.3%	$ 29,309	4.0%	$ 36,637	5.0%

The federal banking agencies, including the FRB and the OCC, maintain risk-based capital standards in order to ensure that those standards take adequate account of interest rate risk, concentration of credit risk, the risk of non-traditional activities and equity investments in non-financial companies, as well as reflect the actual performance and expected risk of loss on certain multifamily housing loans. Bank regulators periodically propose amendments to the risk-based capital guidelines and related regulatory framework, and consider changes to the risk-based capital standards that could significantly increase the amount of capital needed to meet the requirements for the capital tiers described below. While the Company’s management studies such proposals, the timing of adoption, ultimate form and effect of any such proposed amendments on the Company’s capital requirements and operations cannot be predicted.

The federal banking agencies are required to take “prompt corrective action” in respect of depository institutions and their bank holding companies that do not meet minimum capital requirements. The Federal Deposit Insurance Act established five capital tiers: “well capitalized,” “adequately capitalized,” “undercapitalized,” “significantly undercapitalized” and “critically undercapitalized.” A depository institution’s capital tier, or that of its bank holding company, depends upon where its capital levels are in relation to various relevant capital measures, including a risk-based capital measure and a leverage ratio capital measure, and certain other factors.

Under the implementing regulations adopted by the federal banking agencies, a bank holding company or bank is considered “well capitalized” if it has: (i) a total risk-based capital ratio of 10% or greater; (ii) a Tier 1 risk-based capital ratio of 6% or greater; and (iii) a leverage ratio of 5% or greater; and is not subject to any order or written directive to meet and maintain a specific capital level for a capital measure. An “adequately capitalized” bank holding company or bank is defined as one that has: (i) a total risk-based capital ratio of 8% or greater; (ii) a Tier 1 risk-based capital ratio of 4% or greater; and (iii) a leverage ratio of 4% or greater (or 3% or greater in the case of a bank with a composite

CAMELS rating of (1)). A bank holding company or bank is considered (A) “undercapitalized” if it has: (i) a total risk-based capital ratio of less than 8%; (ii) a Tier 1 risk-based capital ratio of less than 4%; or (iii) a leverage ratio of less than 4% (or 3% in the case of a bank with a composite CAMELS rating of (1)); (B) “significantly undercapitalized” if it has: (i) a total risk-based capital ratio of less than 6%; or (ii) a Tier 1 risk-based capital ratio of less than 3%; or (iii) a leverage ratio of less than 3%; and (C) “critically undercapitalized” if it has a ratio of tangible equity to total assets equal to or less than 2%. The FRB may reclassify a “well capitalized” bank holding company or bank as “adequately capitalized” or subject an “adequately capitalized” or “undercapitalized” institution to the supervisory actions applicable to the next lower capital category if it determines that the bank holding company or bank is in an unsafe or unsound condition or deems the bank holding company or bank to be engaged in an unsafe or unsound practice and not to have corrected the deficiency. As of December 31, 2012, the Company and the Bank met the definition of “well capitalized” institutions.

“Undercapitalized” depository institutions, among other things: are subject to growth limitations; are prohibited, with certain exceptions, from making capital distributions; are limited in their ability to obtain funding from a Federal Reserve Bank; and are required to submit a capital restoration plan. The federal banking agencies may not accept a capital plan without determining, among other things, that the plan is based on realistic assumptions and is likely to succeed in restoring the depository institution’s capital. In addition, for a capital restoration plan to be acceptable, the depository institution’s parent holding company must guarantee that the institution will comply with such capital restoration plan and provide appropriate assurances of performance. If a depository institution fails to submit an acceptable plan, including if the holding company refuses or is unable to make the guarantee described in the previous sentence, it is treated as if it is “significantly undercapitalized.” Failure to submit or implement an acceptable capital plan also is grounds for the appointment of a conservator or a receiver. “Significantly undercapitalized” depository institutions may be subject to a number of additional requirements and restrictions, including orders to sell sufficient voting stock to become “adequately capitalized,” requirements to reduce total assets and cessation of receipt of deposits from correspondent banks. Moreover, the parent holding company of a “significantly undercapitalized” depository institution may be ordered to divest itself of the institution or of non-bank subsidiaries of the holding company. “Critically undercapitalized” institutions, among other things, are prohibited from making any payments of principal and interest on subordinated debt, and are subject to the appointment of a receiver or conservator.

Each federal banking agency prescribes standards for depository institutions and depository institution holding companies relating to internal controls, information systems, internal audit systems, loan documentation, credit underwriting, interest rate exposure, asset growth, compensation, a maximum ratio of classified assets to capital, minimum earnings sufficient to absorb losses, a minimum ratio of market value to book value for publicly traded shares and other standards as they deem appropriate. The FRB and the OCC have adopted such standards.

Dodd-Frank Wall Street Reform and Consumer Protection Act

The Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) was signed into law by President Obama on July 21, 2010. It is widely regarded as the most sweeping change to financial regulation since the Great Depression. The law is intended to achieve the following objectives: promote robust supervision and regulation of financial firms; establish comprehensive supervision of financial markets; protect consumers and investors from financial abuse; provide the government with the tools to manage a financial crisis; and raise international regulatory standards and improve international cooperation. The Dodd-Frank Act requires more than 60 studies to be conducted and more than 200 regulations to be written. The true impact of the legislation will be unknown until these are complete. Some of the most significant aspects of The Dodd-Frank Act include:

I. The creation of a new oversight regulator, the Financial Stability Oversight Council. The council of regulators will monitor the financial system for systemic risk and will determine which entities pose significant systemic risk.

II. The Collins Amendment, which imposes a stricter application of risk-based capital requirements for bank holding companies than was previously employed. Under the Collins Amendment, certain depository institutions will not be permitted to include trust preferred securities issued after May 19, 2010 in Tier 1 capital. For depository institutions with greater than $15 billion in assets, trust preferred securities issued before May 19, 2010 will be phased out as a component of Tier 1 Capital over three years beginning January 1, 2013. Evans Bancorp has $11.3 million in trust preferred securities included in Tier 1 Capital, but is well under the $15 billion exemption threshold.

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III. A number of deposit insurance reforms. The first redefines the deposit insurance assessment base to reflect consolidated total assets less average tangible equity. The result is that larger financial institutions, which have more assets leveraged with non-deposit wholesale funds, have paid a greater percentage of the aggregate insurance assessment and smaller banks have paid less than they would have. The Bank has benefited from this provision. This title also increases the minimum reserve ratio of the Deposit Insurance Fund from 1.15% to 1.35%, but exempts institutions with assets less than $10 billion from the cost of the increase. The title also permanently increases deposit insurance coverage to $250,000 and fully covers non-interest bearing transactions accounts through 2012.

IV. Companies with a public market capitalization under $75 million are permanently exempt from the provisions of Section 404(b) of the Sarbanes-Oxley Act ("SOX"), which requires that public companies receive an opinion from their external auditors as to the effectiveness of their internal controls over financial reporting. Under this provision, Evans Bancorp is exempt from SOX 404(b). However, the Audit Committee of the Board of Directors and the Company's management have decided to continue to voluntarily comply with SOX 404(b) as they believe it is in the best interest of the Company. This title also requires the SEC to conduct a study of companies with market capitalization between $75 million and $250 million to determine how the SEC could reduce the burden of complying with the internal control audit requirements.

V. Establishment the Bureau of Consumer Financial Protection ("BCFP"), an independent entity housed with the Federal Reserve. The Dodd-Frank Act gives the BCFP the authority to prohibit practices that it finds to be unfair, deceptive, or abusive in addition to requiring certain disclosures. An important provision of this title limits interchange fees for debit card transactions to an amount established as reasonable under regulations to be issued by the Federal Reserve. Cards issued by banks with less than $10 billion in assets are exempt from this requirement. Despite being exempt from this provision, it is possible that the Bank may be impacted by this provision if the Bank has to match the reduced rates being offered by larger competitors. This could potentially result in the loss of hundreds of thousands of dollars of revenue.

VI. The placement of new regulations on mortgage originators and imposition of new disclosure requirements and appraisal reforms, including: the creation of a mortgage originator duty of care; the establishment of certain underwriting requirements designed to ensure that at the time of origination the consumer has a reasonable ability to repay the loan; the creation of document requirements intended to eliminate "no document" and "low document" loans; the prohibition of steering incentives for mortgage originators; a prohibition on yield spread premiums and prepayment penalties in some cases; and a provision that allows borrowers to assert as a foreclosure defense a contention that the lender violated the anti-steering restrictions or the reasonable repayment requirements.

Basel III

Basel III is a comprehensive set of reform measures, developed by the Basel Committee on Banking Supervision, to strengthen the regulation, supervision and risk management of the banking sector. These measures aim to improve the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source, improve risk management and governance, and strengthen banks' transparency and disclosures.

Basel III would increase capital requirements on all insured depository institutions and bank and thrift holding companies with assets over $500 million. On August 30, 2012, the OCC, the Federal Reserve, and the FDIC published three notices of proposed rulemaking that would revise and replace the agencies' current capital rules consistent with the Basel III framework established internationally. Final rules had not been adopted as of December 31, 2012.

Basel III constitutes a fundamental redefinition of bank capital requirements. It adds a new capital component, common equity Tier 1 capital, and increases the minimum Tier 1 capital ratio requirement. Banks would be required to set aside capital over and above what has been set aside in the past. If capital levels fall below minimum requirements, a new capital conservation buffer framework would limit payments of retained earnings through capital distributions, discretionary executive pay, or stock repurchases.

Common Equity Tier 1 Capital would generally include common stock, retained earnings, and accumulated other comprehensive income. Currently, other comprehensive income is not included in Tier 1 Capital. Similar to Tier 1 Capital today, goodwill and other intangible assets would be deducted from Common Equity Tier 1 Capital. A new ratio called the Common Equity Tier 1 Risk-Based Capital ("RBC") Ratio would be used, which would be calculated by dividing Common Equity Tier 1 by Total Risk-Weighted Assets.

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There would also be a phase-out of Trust Preferred Securities as part of Tier 1 RBC starting in 2013 with a complete phase-out by 2022.

After a phase-in period, the following table depicts the proposed Prompt Corrective Action ("PCA") categories and ratios that would be effective January 1, 2015:

The types of payments that would be restricted if a bank does not satisfy the Capital Conservation Buffer ("CCB") requirement are dividends, share buybacks, discretionary payments on Tier 1 instruments and discretionary bonus payments. Agencies would maintain the supervisory authority to impose further restrictions and/or require capital commensurate with the bank's risk profile.

A bank's CCB would equal the lowest of the following calculations:

(1) Common Equity Tier 1 RBC Ratio minus 4.5%
(2) Tier 1 RBC Ratio minus 6.0%
(3) Total RBC Ratio minus 8.0%

If a bank's CCB is less than 2.5%, the bank would not be able to make restricted payments, as defined above, to the extent that they exceed 60% of Eligible Retained Income ("ERI"). There is a sliding scale that further restricts the restricted payments for banks with CCBs that are 1.875% or less. ERI is defined as the most recent four quarters of net income less any capital distributions and certain discretionary payments and associated tax effects not already reflected in net income.

The CCB would begin to be phased in starting in 2016 with the full 2.5% limit being reached in 2019.

The Basel III reforms would also impose new asset risk weight requirements. These new risk-weightings would include:

- 1st-lien mortgages, which currently are risk-weighted at 50%, will have risk weights ranging from 35% to 100% based on the loan-to-value ratio.
- Junior liens and delinquent loans, currently risk-weighted at 100%, will have risk weights ranging from 100-200%.
- Acquisition, development, and construction financing with LTV's over 90% will be designated as High Volatility Commercial Real Estate and carry a risk weight of 150%.

The Company is currently studying the potential impact of the adoption of Basel III as proposed and awaits the final rules. Potential risks of Basel III to the Company are detailed in the Risk Factors section.

Regulation of Insurance Agency Subsidiary

TEA is regulated by the New York State Insurance Department. As of the date of this report, TEA meets and maintains all licensing and continuing education requirements required by the State of New York.

Monetary Policy and Economic Control

The commercial banking business is affected not only by general economic conditions, but also by the monetary policies of the FRB. Changes in the discount rate on member bank borrowing, availability of borrowing at the "discount

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window," open market operations, the imposition of changes in reserve requirements against member banks' deposits and assets of foreign branches and the imposition of and changes in reserve requirements against certain borrowings by banks and their affiliates are some of the instruments of monetary policy available to the FRB. These monetary policies are used in varying combinations to influence overall growth and distributions of bank loans, investments and deposits, and this use may affect interest rates charged on loans or paid on deposits. The monetary policies of the FRB have had a significant effect on the operating results of commercial banks and are expected to continue to do so in the future. The monetary policies of these agencies are influenced by various factors, including inflation, unemployment, and short-term and long-term changes in the international trade balance and in the fiscal policies of the United States Government. Future monetary policies and the effect of such policies on the future business and earnings of the Company cannot be predicted.

Consumer Laws and Regulations

In addition to the laws and regulations discussed herein, the Bank is also subject to certain consumer laws and regulations that are designed to protect consumers in transactions with banks. These laws and regulations include, but are not limited to, the Truth in Lending Act, the Truth in Savings Act, the Electronic Funds Transfer Act, the Expedited Funds Availability Act, the Equal Credit Opportunity Act, the Fair Housing Act, the Home Mortgage Disclosure Act, the Real Estate Settlement Procedures Act, Federal Financial Privacy Laws, Interagency Guidelines Establishing Information Security Standards, the Right to Financial Privacy Act, and the Fair and Accurate Credit Transactions Reporting Act. These laws and regulations regulate the manner in which financial institutions must deal with customers when taking deposits or making loans to such customers.

EMPLOYEES

As of December 31, 2012, the Company had no direct employees. As of December 31, 2012, the following table summarizes the employment rosters of the Company's subsidiaries using full-time equivalent employees ("FTE"):

	2012	2011	2010	2009	2008
Bank	183	186	164	147	148
ENL	2	2	4	7	12
TEA	49	50	52	57	58
FCS	4	4	4	4	4
	238	242	224	215	222

Management believes that the Company's subsidiaries have good relationships with their employees.

AVAILABLE INFORMATION

The Company's Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and amendments to those reports filed or furnished by the Company pursuant to Section 13(a) or 15(d) of the Exchange Act are available without charge on the Company's website, www.evansbancorp.com - SEC filings section, as soon as reasonably practicable after they are electronically filed with or furnished to the SEC. The Company is providing the address to its Internet site solely for the information of investors. The Company does not intend its Internet address to be an active link or to otherwise incorporate the contents of the website into this Annual Report on Form 10-K or into any other report filed with or furnished to the SEC.

Item 1A.RISK FACTORS

The following factors identified by the Company's management represent significant potential risks that the Company faces in its operations.

The Company’s Business May Be Adversely Affected by Conditions in the Financial Markets and Economic Conditions Generally

The United States was in an economic recession from December 2007-June 2009, according to the U.S. National Bureau of Economic Research. While the recession is technically over, economic growth has been muted and the unemployment rate remains high at 7.8% (per the U.S. Department of Labor) as of December 31, 2012. Business activity across a wide range of industries and regions has been greatly reduced and local governments and many businesses are in serious difficulty due to the high unemployment rate, the lack of consumer spending, and a sluggish housing market. The recession was initially triggered by declines in home prices and the values of subprime mortgages,

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but spread to all mortgage and real estate asset classes, to leveraged bank loans and to nearly all asset classes, including equities. Since the end of the recession there has been some recovery in the value of some asset classes, but the economy remains weak with high unemployment, lower property values, and low consumer confidence.

The Company's financial performance generally, and in particular the ability of borrowers to pay interest on and repay principal of outstanding loans and leases and the value of collateral securing those loans and leases, is highly dependent upon the business environment in the markets where the Company operates, in Western New York and in the United States as a whole. A favorable business environment is generally characterized by, among other factors, economic growth, efficient capital markets, low inflation, high business and investor confidence, and strong business earnings. Unfavorable or uncertain economic and market conditions can be caused by: declines in economic growth, declines in housing and real estate valuations, business activity or investor or business confidence; limitations on the availability or increases in the cost of credit and capital; increases in inflation or interest rates; natural disasters; or a combination of these or other factors.

Overall, during 2012, the business environment continued to be adverse for many households and businesses in the United States and worldwide. It is expected that the business environment in Western New York, the United States and worldwide will continue to be slow to recover from the recession. There can be no assurance that these conditions will improve substantially in the near term. Such conditions could materially adversely affect the credit quality of the Company's loans and leases, and therefore, the Company's results of operations and financial condition.

Commercial Real Estate and Commercial Business Loans Expose the Company to Increased Credit Risks

At December 31, 2012, the Company's portfolio of commercial real estate loans totaled $352.7 million, or 60.5% of total loans and leases outstanding, and the Company's portfolio of commercial and industrial ("C&I") loans totaled $100.0 million, or 17.2% of total loans and leases outstanding. The Company plans to continue to emphasize the origination of commercial loans as they generally earn a higher rate of interest than other loan products offered by the Bank. Commercial loans generally expose a lender to greater risk of non-payment and loss than one-to four-family residential mortgage loans because repayment of commercial real estate and C&I loans often depends on the successful operations and the income stream of the borrowers. Commercial mortgages are collateralized by real property while C&I loans are typically secured by business assets such as equipment and accounts receivable. Such loans typically involve larger loan balances to single borrowers or groups of related borrowers compared to one-to four-family residential mortgage loans. Also, many of the Company's commercial borrowers have more than one commercial real estate or C&I loan outstanding with the Company. Consequently, an adverse development with respect to one loan or one credit relationship can expose the Company to a significantly greater risk of loss compared to an adverse development with respect to a one-to four-family residential mortgage loan. Commercial real estate loans in non-accrual status at December 31, 2012 were $5.0 million, compared with $8.3 million at December 31, 2011. C&I loans in non-accrual status at December 31, 2012 were $0.9 million, compared with $2.2 million at December 31, 2011. Increases in the delinquency levels of commercial real estate and C&I loans could result in an increase in non-performing loans and provision for loan and lease losses, which could have a material adverse effect on our results of operations and financial condition.

Continuing Concentration of Loans in the Company's Primary Market Area May Increase the Company's Risk

Unlike larger banks that are more geographically diversified, the Company provides banking and financial services to customers located primarily in western New York State ("WNY"). Therefore, the Company's success depends primarily on the general economic conditions in WNY. The Company's business lending and marketing strategies focus on loans to small and medium-sized businesses in this geographic region. Moreover, the Company's assets are heavily concentrated in mortgages on properties located in WNY. Accordingly, the Company's business and operations are vulnerable to downturns in the economy of WNY. The concentration of the Company's loans in this geographic region subjects the Company to the risk that a downturn in the economy or recession in this region could result in a decrease in loan originations and increases in delinquencies and foreclosures, which would more greatly affect the Company than if the Company's lending were more geographically diversified. In addition, the Company may suffer losses if there is a decline in the value of properties underlying the Company's mortgage loans which would have a material adverse impact on the Company's operations.

In the Event the Company's Allowance for Loan and Lease Losses is Not Sufficient to Cover Actual Loan and Lease Losses, the Company's Earnings Could Decrease

The Company maintains an allowance for loan and lease losses in order to capture the probable losses inherent in its loan and lease portfolio. There is a risk that the Company may experience significant loan and lease losses which could exceed the allowance for loan and lease losses. In determining the amount of the Company's recorded allowance, the Company makes various assumptions and judgments about the collectability of its loan and lease portfolio, including the creditworthiness of its borrowers, the effect of changes in the local economy on the value of the real estate and other

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assets serving as collateral for the repayment of loans, the effects on the Company's loan and lease portfolio of current economic indicators and their probable impact on borrowers, and the Company's loan quality reviews. The emphasis on the origination of commercial real estate and C&I loans is a significant factor in evaluating an allowance for loan and lease losses. As the Company continues to increase the amount of these loans in the portfolio, additional or increased provisions for loan and lease losses may be necessary and would adversely affect the results of operations. In addition, bank regulators periodically review the Company's loan and lease portfolio and credit underwriting procedures, as well as its allowance for loan and lease losses, and may require the Company to increase its provision for loan and lease losses or recognize further loan and lease charge-offs. At December 31, 2012, the Company had a gross loan portfolio of approximately \$582.9 million and the allowance for loan and lease losses was approximately \$9.7 million, which represented 1.67% of the total amount of gross loans and leases. If the Company's assumptions and judgments prove to be incorrect or bank regulators require the Company to increase its provision for loan and lease losses or recognize further loan and lease charge-offs, the Company may have to increase its allowance for loan and lease losses or loan and lease charge-offs which could have an adverse effect on the Company's operating results and financial condition. There can be no assurances that the Company's allowance for loan and lease losses will be adequate to protect the Company against loan and lease losses that it may incur.

Changes in Interest Rates Could Adversely Affect the Company's Business, Results of Operations and Financial Condition

The Company's results of operations and financial condition are significantly affected by changes in interest rates. The Company's results of operations depend substantially on its net interest income, which is the difference between the interest income earned on its interest-earning assets and the interest expense paid on its interest-bearing liabilities. Because the Company's interest-bearing liabilities generally re-price or mature more quickly than its interest-earning assets, an increase in interest rates generally would tend to result in a decrease in its net interest income.

Changes in interest rates also affect the value of the Company's interest-earning assets, and in particular, the Company's securities portfolio. Generally, the value of securities fluctuates inversely with changes in interest rates. At December 31, 2012, the Company's securities available for sale totaled \$95.8 million. Net unrealized gains on securities available for sale, net of tax, amounted to \$2.4 million and are reported as a separate component of stockholders' equity. Decreases in the fair value of securities available for sale, therefore, could have an adverse effect on stockholders' equity or earnings.

The Company also is subject to reinvestment risk associated with changes in interest rates. Changes in interest rates may affect the average life of loans and mortgage-related securities. Decreases in interest rates can result in increased prepayments of loans and mortgage-related securities, as borrowers refinance to reduce borrowing costs. Under these circumstances, the Company is subject to reinvestment risk to the extent that it is unable to reinvest the cash received from such prepayments at rates that are comparable to the rates on existing loans and securities. Additionally, increases in interest rates may decrease loan demand and make it more difficult for borrowers to repay adjustable rate loans.

In an effort to support a stronger economic recovery and to help ensure that inflation, over time, is at the rate most consistent with its dual mandate, the Federal Open Market Committee (the "Fed") announced in September 2012 that it would increase policy accommodation by purchasing additional agency mortgage-backed securities at a pace of $40 billion per month. The Fed also said that it would continue through the end of 2012 its program to extend the average maturity of its holdings of securities as announced in June 2012, and would maintain its existing policy of reinvesting principal payments from its holdings of agency debt and agency mortgage-backed securities back into agency mortgage-backed securities. These actions, which together increased the Fed's holdings of longer-term securities by about $85 billion each month through the end of 2012, are expected to put downward pressure on longer-term interest rates, support mortgage markets, and help to make broader financial conditions more accommodative.

The Fed said that it would closely monitor incoming information on economic and financial developments in coming months. If the outlook for the labor market does not improve substantially, the Fed advised that it will continue its purchases of agency mortgage-backed securities, undertake additional asset purchases, and employ its other policy tools as appropriate until such improvement is achieved in a context of price stability.

To support continued progress toward maximum employment and price stability, the Fed said that it expects that a highly accommodative stance of monetary policy will remain appropriate for a considerable time after the economic recovery strengthens. In particular, the Fed also decided to keep the target range for the federal funds rate at 0 to 1/4 percent and currently anticipates that exceptionally low levels for the federal funds rate are likely to be warranted at least through mid-2015. The Fed further clarified these guidelines in December 2012 by stating that the current exceptionally low

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federal funds target rate would remain in place until the unemployment rate went below 6.5% and the projected inflation rate rose above 2.5%

Easy monetary policy by the FRB may increase the interest rate risk for the Company by lowering interest rates over the near term, but also by inadvertently causing inflation to rise at a rapid pace once the economy more fully rebounds from the recession. High inflation rates are usually accompanied by an increase in interest rates.

The Fed's current accommodative stance has resulted in extraordinarily low interest rates during the past three years and played a part in compressing the Company's net interest margin from 4.16% in 2010 to 3.99% in 2011 and 3.84% in 2012. While assets continue to re-price into lower rates as loans and investments mature, the re-pricing opportunities on the liability side have mostly been exhausted. Further compression of the Company's net interest margin could occur as a result of the Fed's accommodative monetary policy, which could have a material adverse effect on the Company's results of operations and financial condition.

The Company May Be Adversely Affected by the Soundness of Other Financial Institutions

Financial services institutions are interrelated as a result of counterparty relationships. The Company has exposure to many different industries and counterparties, and routinely executes transactions with counterparties in the financial services industry. The most important counterparty for the Company, in terms of liquidity, is the Federal Home Loan Bank of New York ("FHLBNY"). The Company uses FHLBNY as its primary source of overnight funds and also has several long-term advances with FHLBNY. At December 31, 2012, the Company had a total of $19.0 million in borrowed funds with FHLBNY. The Company has placed sufficient collateral in the form of commercial and residential real estate loans at FHLBNY. As a member of the Federal Home Loan Bank System, the Bank is required to hold stock in FHLBNY. The Bank held FHLBNY stock with a fair value of $1.8 million as of December 31, 2012. The Bank's FHLBNY stock average yield in 2012 was 4.7%.

There are 12 branches of the FHLB, including New York. If a member was at risk of breaching risk-based capital requirements, it could suspend dividends, cut dividend payments, and/or not buy back excess FHLB stock that members hold. FHLBNY has stated that they expect to be able to continue to pay dividends, redeem excess capital stock, and provide competitively priced advances in the future. Nonetheless, the 12 FHLB branches are jointly liable for the consolidated obligations of the FHLB system. To the extent that one FHLB branch cannot meet its obligations to pay its share of the system's debt; other FHLB branches can be called upon to make the payment.

Systemic weakness in the FHLB could result in higher costs of FHLB borrowings, reduced value of FHLB stock, and increased demand for alternative sources of liquidity that are more expensive, such as brokered time deposits, the discount window at the Federal Reserve, or lines of credit with correspondent banks First Tennessee Bank and M&T Bank.

Strong Competition Within the Company's Market Area May Limit its Growth and Profitability

Competition in the banking and financial services industry is intense. The Company competes with commercial banks, savings institutions, mortgage brokerage firms, credit unions, finance companies, mutual funds, insurance companies, and brokerage and investment banking firms operating locally within the Company's market area and elsewhere. Many of these competitors (whether regional or national institutions) have substantially greater resources and lending limits than the Company does, and may offer certain services that the Company does not or cannot provide. The Company's profitability depends upon its continued ability to successfully compete in this market area.

Expansion of the Company’s Branch Network May Adversely Affect its Financial Results

The Company opened a new branch office in October 2012. The Company cannot assure that its branch expansion strategy will be accretive to earnings or that it will be accretive to earnings within a reasonable period of time. Numerous factors contribute to the performance of a new branch, such as suitable location, qualified personnel, and an effective marketing strategy. Additionally, it takes time for a new branch to gather sufficient loans and deposits to generate income sufficient to cover its operating expenses. Difficulties the Company experiences in implementing its growth strategy may have a material adverse effect on the Company’s financial condition and results of operations.

The Company Operates in a Highly Regulated Environment and May Be Adversely Affected By Changes in Laws and Regulations

The Company and its subsidiaries are subject to regulation, supervision and examination by the OCC, FRB, and by the FDIC, as insurer of its deposits. Such regulation and supervision govern the activities in which a bank and its holding company may engage and are intended primarily for the protection of the deposit insurance funds and depositors. Regulatory requirements affect the Company's lending practices, capital structure, investment practices, dividend policy and growth. These regulatory authorities have extensive discretion in connection with their supervisory and enforcement activities, including the imposition of restrictions on the operation of a bank, the imposition of deposit insurance premiums and other assessments, the classification of assets by a bank and the adequacy of a bank's allowance for loan and lease losses. Any change in such regulation and oversight, particularly through the new rules and regulations expected to be established by the Dodd-Frank Act and Basel III, could have a material adverse impact on the Bank, the Company and its business, financial condition and results of operations.

The impending capital requirement changes from Basel III discussed in Item 1 could have a material adverse impact on the Company. Even though the Bank exceeds current and proposed minimum regulatory capital levels, adverse changes to residential mortgage risk weights, new requirements for common equity capital, inclusion of accumulated other comprehensive income in regulatory capital, the phase out of trust preferred securities, along with the adoption of new capital conservation buffers would deplete the Bank’s current capital position and over time could cause the Bank to fail to meet minimum regulatory requirements. While the Company has a positive balance in accumulated other comprehensive income as of December 31, 2012, these positions are subject to volatility due to changes in interest rates and credit spreads. The current positive balance is a product of the continued ultra low interest rate environment, which could change in the future. Rapid increases in interest rates and credit spreads could reverse the gain position and force the Company’s accumulated other comprehensive income to become negative and have an adverse impact on the Bank’s regulatory capital. Although there is a phase-in period in the proposed rules, other headwinds such as the ultra-low interest rate environment, fragile economic recovery, possible recession, and further constraints on profitability by regulators could impact the Bank’s ability to meet the new regulatory minimums once the phase-in periods have ended.

Lack of System Integrity or Credit Quality Related to Funds Settlement could Result in a Financial Loss

The Bank settles funds on behalf of financial institutions, other businesses and consumers and receives funds from clients, card issuers, payment networks and consumers on a daily basis for a variety of transaction types. Transactions facilitated by the Bank include debit card, credit card and electronic bill payment transactions, supporting consumers, financial institutions and other businesses. These payment activities rely upon the technology infrastructure that facilitates the verification of activity with counterparties and the facilitation of the payment. If the continuity of operations or integrity of processing were compromised this could result in a financial loss to the Bank, and therefore the Company, due to a failure in payment facilitation. In addition, the Bank may issue credit to consumers, financial institutions or other businesses as part of the funds settlement. A default on this credit by a counterparty could result in a financial loss to the Bank, and therefore to the Company.

Financial Services Companies Depend on the Accuracy and Completeness of Information about Customers and Counterparties

In deciding whether to extend credit or enter into other transactions, the Company may rely on information furnished by or on behalf of customers and counterparties, including financial statements, credit reports, and other financial information. The Company may also rely on representations of those customers, counterparties, or other third parties, such as independent auditors, as to the accuracy and completeness of that information. While management generally engages only third parties that it knows or believes to be reputable, reliance on inaccurate or misleading financial statements, credit reports, or other financial information could cause the Company to enter into unfavorable transactions, which could have a material adverse effect on the Company's financial condition and results of operations.

Loss of Key Employees May Disrupt Relationships with Certain Customers

The Company's business is primarily relationship-driven in that many of the Company's key employees have extensive customer relationships. Loss of a key employee with such customer relationships may lead to the loss of business if the customers were to follow that employee to a competitor. While management believes that the Company's relationships with its key business producers are good, the Company cannot guarantee that all of its key personnel will remain with the organization. Loss of such key personnel, should they enter into an employment relationship with one of the Company's competitors, could result in the loss of some of the Company's customers. Such losses could have a material adverse effect on the Company's business, financial condition and results of operations.

Future FDIC Insurance Premium Increases May Adversely Affect the Company's Earnings

The Company is generally unable to control the amount of premiums that it is required to pay for FDIC insurance. If there are additional bank or financial institution failures or other similar occurrences, the FDIC may again increase the

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premiums assessed upon insured institutions. Such increases and any future increases or required prepayments of FDIC insurance premiums may adversely impact the Company's results of operations.

The Company is a Financial Holding Company and Depends on Its Subsidiaries for Dividends, Distributions and Other Payments

The Company is a legal entity separate and distinct from its banking and other subsidiaries. The Company's principal source of cash flow, including cash flow to pay dividends to the Company's stockholders and principal and interest on its outstanding debt, is dividends from the Bank. There are statutory and regulatory limitations on the payment of dividends by the Bank, as well as the payment of dividends by the Company to its stockholders. Regulations of the OCC affect the ability of the Bank to pay dividends and other distributions and to make loans to the Company. If the Bank is unable to make dividend payments and sufficient capital is not otherwise available, the Company may not be able to make dividend payments to its common stockholders or principal and interest payments on its outstanding debt.

Because the Nature of the Financial Services Business Involves a High Volume of Transactions, the Company Faces Significant Operational Risks

The Company operates in diverse markets and relies on the ability of its employees and systems to process a high number of transactions. Operational risk is the risk of loss resulting from the Company's operations, including but not limited to, the risk of fraud by employees or persons outside of the Company, the execution of unauthorized transactions by employees, errors relating to transaction processing and technology, breaches of the internal control system and compliance requirements, and business continuation and disaster recovery. This risk of loss also includes the potential legal actions that could arise as a result of an operational deficiency or as a result of noncompliance with applicable regulatory standards, adverse business decisions or their implementation, and customer attrition due to potential negative publicity. In the event of a breakdown in the internal control system, improper operation of systems or improper employee actions, the Company could suffer financial loss, face regulatory action and suffer damage to its reputation.

The Company's Information Systems may Experience an Interruption or Breach in Security

The Company relies heavily on communications and information systems to conduct its business. Any failure, interruption, or breach in security or operational integrity of these systems could result in failures or disruptions in the Company's customer relationship management, general ledger, deposit, loan, and other systems. While the Company has policies and procedures designed to prevent or limit the effect of the failure, interruption, or security breach of its information systems, there can be no assurance that any such failures, interruptions, or security breaches will not occur or, if they do occur, that they will be adequately addressed. If personal, nonpublic, confidential, or proprietary information of customers in the Company's possession were to be mishandled or misused, we could suffer significant regulatory consequences, reputational damage, and financial loss. Such mishandling or misuse could include, for example, if such information were erroneously provided to parties who are not permitted to have the information, either by fault of the Company's systems, employees or counterparties, or where such information is intercepted or otherwise inappropriately taken by third parties. The occurrence of any failures, interruptions, or security breaches of the Company's information systems could damage the Company's reputation, result in a loss of customer business, subject the Company to additional regulatory scrutiny, or expose the Company to civil litigation and possible financial liability, any of which could have a material adverse effect on the Company's financial condition and results of operations.

The Potential for Business Interruption Exists Throughout the Company's Organization

Integral to the Company's performance is the continued efficacy of our technical systems, operational infrastructure, relationships with third parties and the vast array of associates and key executives in the Company's day-to-day and ongoing operations. Failure by any or all of these resources subjects the Company to risks that may vary in size, scale and scope. This includes, but is not limited to, operational or technical failures, pandemics, ineffectiveness or exposure due to interruption in third party support as expected, as well as the loss of key individuals or failure on the part of key individuals to perform properly. Although management has established policies and procedures to address such failures, the occurrence of any such event could have a material adverse effect on the Company's business, which, in turn, could have a material adverse effect on its financial condition and results of operations.

Environmental Factors May Create Liability

In the course of its business, the Bank has acquired and may acquire in the future, property securing loans that are in default. There is a risk that the Bank could be required to investigate and clean-up hazardous or toxic substances or chemical releases at such properties after acquisition by the Bank in a foreclosure action, and that the Bank may be held liable to a governmental entity or third parties for property damage, personal injury and investigation and clean-up costs incurred by such parties in connection with such contamination. In addition, the owner or former owners of

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contaminated sites may be subject to common law claims by third parties based on damages and costs resulting from environmental contamination emanating from such property. To date, the Bank has not been required to perform any investigation or clean-up activities, nor has it been subject to any environmental claims. There can be no assurance, however, that this will remain the case in the future.

Anti-takeover Laws and Certain Agreements and Charter Provisions May Adversely Affect Share Value

Certain provisions of the Company's certificate of incorporation and state and federal banking laws, including regulatory approval requirements, could make it more difficult for a third party to acquire control of the Company without approval of the Company's board of directors. Under federal law, subject to certain exemptions, a person, entity or group must notify the FRB before acquiring control of a bank holding company. Acquisition of 10% or more of any class of voting stock of a bank holding company, including shares of the Company's common stock, creates a rebuttable presumption that the acquiror "controls" the bank holding company. Also, a bank holding company must obtain the prior approval of the FRB before, among other things, acquiring direct or indirect ownership or control of more than 5% of the voting shares of any bank, including the Bank. There also are provisions in the Company's certificate of incorporation that may be used to delay or block a takeover attempt. Taken as a whole, these statutory provisions and provisions in the Company's certificate of incorporation could result in the Company being less attractive to a potential acquiror and thus could adversely affect the market price of the Company's common stock.

Item 1B.UNRESOLVED STAFF COMMENTS

None.

Item 2.PROPERTIES

The Bank conducts its business from its administrative office and 13 branch offices as of December 31, 2012. The Bank's administrative office is located at One Grimsby Drive in Hamburg, NY. The administrative office facility is 26,000 square feet and is owned by the Bank. This facility is occupied by the Office of the President and Chief Executive Officer of the Company, as well as the Administrative and Loan Divisions of the Bank. The Bank also owns a building on Erie Road in Derby, NY that houses its Employee Training and Operations Center.

The Bank has 13 branch locations. The Bank owns the building and land for five locations. The Bank owns the building but leases the land for four locations. Four other locations are leased.

The Bank also owns the headquarters for SDS at Baseline Road in Grand Island, NY.

TEA operates from its headquarters, a 9,300 square foot office located at 16 North Main Street, Angola, NY, which is owned by the Bank. TEA has 7 retail locations. TEA leases 4 of the locations. The Bank owns two of the locations and TEA owns the remaining building.

The Company owned $11.4 million in properties and equipment, net of depreciation at December 31, 2012, compared with $10.5 million at December 31, 2011.

Item 3.LEGAL PROCEEDINGS

The nature of the Company’s business generates a certain amount of litigation involving matters arising in the ordinary course of business. However, in the opinion of management of the Company, there are no proceedings pending to which the Company is a party or to which its property is subject, which, if determined adversely, would have a material effect on the Company’s results of operations or financial condition.

Item 4.MINE SAFETY DISCLOSURES

Not applicable.

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PART II

Item 5.MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED

STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Market Information. The Company's common stock is listed on the NYSE MKT under the symbol EVBN.

The following table shows, for the periods indicated, the high and low sales prices per share of the Company's common stock for fiscal 2012 and 2011 as reported on the NYSE MKT.

	2012		2011	
QUARTER	High	Low	High	Low
FIRST	$14.35	$11.95	$15.12	$14.00
SECOND	$16.49	$14.15	$14.35	$13.20
THIRD	$17.95	$15.45	$13.95	$10.90
FOURTH	$16.90	$15.25	$12.34	$10.75

Holders. The approximate number of holders of record of the Company's common stock at March 1, 2013 was 1,347.

Cash Dividends. The Company paid the following cash dividends on shares of the Company's common stock during fiscal 2011 and 2012:

- A cash dividend of $0.20 per share on April 4, 2011 to holders of record on March 10, 2011.
- A cash dividend of $0.20 per share on October 4, 2011 to holders of record on September 12, 2011.
- A cash dividend of $0.22 per share on April 10, 2012 to holders of record on March 20, 2012.
- A cash dividend of $0.22 per share on October 9, 2012 to holders of record on September 11, 2012.
- A cash dividend of $0.24 per share on December 31, 2012 to holders of record on December 24, 2012.

In 2012, the Company decided it was appropriate to move up the normal semi-annual dividend for April 2013 to December 2012. At the time of the Company's decision, there was much uncertainty around the income tax rates on dividend income. These rates were expiring on December 31, 2012 and it was expected that these rates would increase in 2013. Therefore, in an effort to reduce the tax burden on shareholders, management and the Board of Directors determined that it would be appropriate and in the best interests of the Company's shareholders to pay a third dividend in 2012 in lieu of the first semi-annual dividend in 2013.

The amount and type (cash or stock), if any, of future dividends will be determined by the Company's Board of Directors and will depend upon the Company's earnings, financial conditions and other factors considered by the Board of Directors to be relevant. The Bank pays a dividend to the Company to provide funds for: debt service on the junior subordinated debentures, a portion of the proceeds of which were contributed to the Bank as capital; dividends the Company pays; treasury stock repurchases; and other Company expenses. As discussed above under "Item 1A. Risk Factors," the Company is dependent upon cash flow from its subsidiaries in order to fund its dividend payments. There are various legal limitations with respect to the Bank's ability to supply funds to the Company. In particular, under Federal banking law, the approval of the FRB and OCC may be required in certain circumstances, prior to the payment of dividends by the Company or the Bank. See Note 20 to the Company's Consolidated Financial Statements included in Part II, Item 8 of this Annual Report on Form 10-K for additional information concerning contractual and regulatory restrictions on the payment of dividends.

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PERFORMANCE GRAPH

The following Performance Graph compares the Company's cumulative total stockholder return on its common stock for a five-year period (December 31, 2007 to December 31, 2012) with the cumulative total return of the NYSE MKT Composite Index and the NASDAQ Bank Index. The comparison for each of the periods assumes that $100 was invested on December 31, 2007 in each of the Company's common stock and the stocks included in the NYSE MKT Composite Index and NASDAQ Bank Index, and that all dividends were reinvested without commissions. This table does not forecast future performance of the Company's stock.

Compare 5-Year Cumulative Total Return Among

Evans Bancorp, Inc.,

NYSE MKT Composite Index, and NASDAQ Bank Index

In accordance with and to the extent permitted by applicable law or regulation, the information set forth above under the heading "Performance Graph" shall not be incorporated by reference into any future filing under the Securities Act, as amended, or the Exchange Act except to the extent that we specifically incorporate it by reference into such filing, and shall not be deemed to be "soliciting material" or to be "filed" with the SEC under the Securities Act or the Exchange Act, or subject to the liabilities of Section 18 of the Exchange Act.

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Purchases of Equity Securities by the Issuer and Affiliated Purchasers. The following table includes all Company repurchases, including those made pursuant to publicly announced plans or programs during the quarter ended December 31, 2012.

Period	Total Number of Shares Purchased (1)	Average Price Paid per Share
October 2012:		
October 1, 2012 - October 31, 2012	-	$
November 2012:		
November 1, 2012 - November 30, 2012	9,493	$ 15.85
December 2012:		
December 1, 2012 - December 31, 2012	-	$
Total	9,493	$ 15.85

(1) The total number of shares purchased in the period consists of shares constructively tendered to the Company by attestation in satisfaction of the exercise price due upon the exercise of options issued pursuant to the Company's 2009 Long-Term Incentive Plan. The "average price paid per share" reported in the table above is the fair market value of the Company's common stock on the exercise date, which was the closing sales price of the Company's common stock as reported on the NYSE MKT on that date.

(1)

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Item 6. SELECTED FINANCIAL DATA

	As of and for the year ended December 31, (Dollars in thousands except per share data)				
Balance Sheet Data	2012	2011	2010	2009	2008
Assets	$ 809,676	$ 740,902	$ 671,523	$ 619,444	$ 528,974
Interest-earning assets	750,287	682,140	611,141	562,219	477,496
Investment securities	95,807	103,783	89,562	75,443	72,190
Loans and leases, net	573,163	571,910	517,554	482,597	401,626
Deposits	678,992	616,203	544,457	499,508	403,953
Borrowings	42,441	42,340	52,226	63,146	66,512
Stockholders' equity	74,828	68,988	63,064	45,959	45,919
Income Statement Data					
Net interest income	$ 27,780	$ 25,988	$ 24,495	$ 22,594	$ 19,268
Non-interest income	12,823	12,432	12,633	14,067	11,677
Non-interest expense	28,792	27,241	26,107	26,057	20,440
Net income	8,132	6,112	4,840	707	4,908
Per Share Data					
Earnings per share – basic	$ 1.96	$ 1.49	$ 1.34	$ 0.25	$ 1.78
Earnings per share – diluted	1.95	1.49	1.34	0.25	1.78
Cash dividends	0.68	0.40	0.40	0.61	0.78
Book value	17.94	16.72	15.45	16.34	16.57
Performance Ratios					
Return on average assets	1.04%	0.86%	0.75%	0.12%	1.03%
Return on average equity	11.20	9.17	8.35	1.57	10.82
Net interest margin	3.84	3.99	4.16	4.33	4.53
Efficiency ratio *	70.05	69.68	67.90	63.16	63.87
Dividend payout ratio	34.69	26.85	29.85	244.00	43.82
Capital Ratios					
Tier I capital to average assets	9.69%	9.71%	9.93%	7.80%	9.02%
Equity to assets	9.24	9.31	9.39	7.42	8.68
Asset Quality Ratios					
Total non-performing assets to total assets	1.02%	2.05%	2.07%	2.10%	0.69%
Total non-performing loans and leases to total loans and leases	1.41	2.60	2.64	2.64	0.88

Net charge-offs to average loans and leases	0.29	0.26	0.10	2.19	0.55
Allowance for loan and lease losses to total loans and leases	1.67	1.97	1.97	1.42	1.49

See Item 7, “Management’s Discussion and Analysis of Financial Condition and Results of Operations,” and Item 8, “Consolidated Financial Statements and Supplementary Data,” of this Report on Form 10-K for further information and analysis of changes in the Company's financial condition and results of operations.

* The calculation of the efficiency ratio excludes amortization of intangibles, goodwill impairment, and gains and losses on sales and calls of securities, for comparative purposes.

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Item 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

OVERVIEW

This discussion is intended to compare the performance of the Company for the years ended December 31, 2012, 2011 and 2010. The review of the information presented should be read in conjunction with Part I, Item 1: "Business" and Part II, Item 6: "Selected Financial Data" and Item 8: "Financial Statements and Supplementary Data" of this Annual Report on Form 10-K.

The Company is a financial holding company registered under the BHCA. The Company currently conducts its business through its two direct wholly-owned subsidiaries: the Bank and the Bank's subsidiaries, ENL and ENHC; and ENFS and its subsidiary, TEA. The Company does not engage in any other substantial business. Unless the context otherwise requires, the term "Company" refers collectively to Evans Bancorp, Inc. and its subsidiaries.

Summary

In 2012, the Company experienced strong earnings results largely driven by a significantly lower provision for loan and lease losses. The Company's stated public intentions are to continue to grow to increase market share and achieve scale while improving profitability and returning value to shareholders. Net income in 2012 was $8.1 million, a 32.8% increase over the 2011 net income of $6.1 million and well above the 2010 net income of $4.8 million. The Company's net income trend reflects the improving credit quality of its loan and lease portfolio. In 2010, the Company recorded $1.5 million in provision for lease losses despite ceasing new lease origination in April 2009 as credit quality continued to deteriorate. The Company also recorded $2.4 million in provision for loan losses in 2010. Non-performing loans and leases as a percentage of total loans and leases was 2.64% as of December 31, 2010. In 2011, the Company reduced its allowance for lease losses by $0.5 million as the level of leasing losses decreased to a point that management determined that a reduction in the allowance was appropriate. The provision for loan losses was increased to $3.0 million in 2011. In 2012, the leasing portfolio was reduced to only $1.6 million (down from a high of $58.6 million at December 31, 2008) and the provision for lease losses was a negative $0.9 million as performance continued to improve and further reductions in reserves were necessary. The loan portfolio's credit performance also improved in 2012 with the non-performing loans and leases as a percentage of total loans and leases declining to 1.41% at December 31, 2012, compared to 2.60% at December 31, 2011. This improvement, combined with relatively flat loan growth in 2012, resulted in a provision for loan losses of only $0.8 million. Overall, the provision for loan and lease losses for the Company decreased from $3.9 million in 2010 to $2.5 million in 2011 to negative $0.1 million in 2012.

As for the Company's core performance, 2012 was marked by solid growth in deposits and flat loan balances in the face of the continued headwinds of a sluggish economy and a very competitive local market in Western New York. The Company experienced some large loan pay-offs in the fourth quarter of 2012, in contrast to the fourth quarter of 2011 which saw significant balance growth. The overall result was a year-over-year decline in total gross loans of $0.5 million, or 0.1% as of December 31, 2012, but an increase in average total loans and leases of $44.0 million, or 8.2%, in 2012 when compared with 2011. The growth in average loans and leases combined with the 10.8% increase in average deposits in 2012 helped drive a 6.9% increase in net interest income, despite a 15 basis point decrease in net interest margin to 3.84% as the ultra low interest rate environment continued to put pressure on the Company's net interest margin. To support the Company's high organic growth rates and increasing regulatory requirements, management has needed to make investments in people and infrastructure, resulting in an increase in non-interest expenses. Most notably, the Bank opened its newest branch in Williamsville, NY in the fourth quarter of 2012. Non-interest income increased 3.2% in 2012 when compared with 2011, driven by a considerable increase in its premiums on loans sold to Fannie Mae, and with measured increases in the Company's two largest sources on non-interest income, service charges of deposits and insurance agency revenue.

Strategy

To sustain future growth and to meet the Company's financial objectives, the Company has defined a number of strategies. Five of the more important strategies are:

- Growing the business to achieve better scale and leverage investments in the banking and insurance agency business for enhanced profitability;
- Opportunistic growth through acquisition;
- Continuing growth of non-interest income through insurance agency internal growth, financial services revenues, employee benefits insurance and retirement programs sales, and cash management;

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- Continue to develop opportunities with a segmented market approach to develop more profitable relationships, less sensitive to pricing, positively impacting earnings; and
- Maintaining a community based focus and providing a personal touch to customer service.

The Company's strategies are designed to direct tactical investment decisions supporting its financial objectives. While the Company intends to focus its efforts on the pursuit of these strategies, there can be no assurance that the Company will successfully implement these strategies or that the strategies will produce the desired results. The Company's most significant revenue source continues to be net interest income, defined as total interest income less interest expense. Net interest income accounted for approximately 68% of total revenue in 2012. To produce net interest income and consistent earnings growth over the long-term, the Company must generate loan and deposit growth at acceptable margins within its market area. To generate and grow loans and deposits, the Company must focus on a number of areas including, but not limited to, opportunistic branch expansion, sales practices, customer and employee satisfaction and retention, competition, evolving customer behavior, technology, product innovation, interest rates, credit performance of its customers and vendor relationships.

The Company also considers non-interest income important to its continued financial success. Fee income generation is partly related to the Company's loan and deposit operations, such as deposit service charges, as well as to its financial products, such as commercial and personal insurance sold through TEA. Improved performance in non-interest income can help increase capital ratios because most of the non-interest income is generated without recording assets on the balance sheet. The Company has and will continue to face challenges in increasing its non-interest income as the regulatory environment changes.

While the Company reviews and manages all customer units, it has focused increased efforts on targeted segments in its community such as (1) smaller businesses with smaller credit needs but rich in deposits and other services; (2) middle market commercial businesses; (3) commercial real estate lending; and (4) retail customers. The overarching goal is to cross-sell between our insurance, financial services and banking lines of business to deepen our relationships with all of our customers. The Company believes that these efforts resulted in growth in the commercial loan portfolio and core deposits during fiscal 2012 and 2011.

The Bank opened a new branch office in Williamsville, NY in October 2012. With all new and existing branches, the Company has strived to provide a personal touch to customer service and is committed to maintaining a local community based philosophy. The Bank has emphasized hiring local branch and lending personnel with strong ties to the specific local communities it enters and serves.

The Bank serves its market through 14 banking offices in Western New York, located in Amherst, Buffalo, Clarence, Derby, Evans, Forestville, Hamburg, Lancaster, North Boston, Tonawanda, West Seneca, and Williamsville. The Company's principal source of funding is through deposits, which it reinvests in the community in the form of loans and investments. Deposits are insured up to the maximum permitted by the Insurance Fund of the FDIC. The Bank is regulated by the OCC.

APPLICATION OF CRITICAL ACCOUNTING ESTIMATES

The Company's Consolidated Financial Statements are prepared in accordance with U.S. generally accepted accounting principles ("GAAP") and follow general practices within the industries in which it operates. Application of these principles requires management to make estimates, assumptions and judgments that affect the amounts reported in the Company's Consolidated Financial Statements and Notes. These estimates, assumptions and judgments are based on information available as of the date of the Consolidated Financial Statements. Accordingly, as this information changes, the Consolidated Financial Statements could reflect different estimates, assumptions and judgments. Certain policies inherently have a greater reliance on the use of estimates, assumptions and judgments, and as such, have a greater possibility of producing results that could be materially different than originally reported.

The most significant accounting policies followed by the Company are presented in Note 1 to the Consolidated Financial Statements included in Item 8 of this Annual Report on Form 10-K. These policies, along with the disclosures presented in the other Notes to the Company's Consolidated Financial Statements contained in this Annual Report on Form 10-K and in this financial review, provide information on how significant assets and liabilities are valued in the Company's Consolidated Financial Statements and how those values are determined.

Estimates, assumptions and judgments are necessary when assets and liabilities are required to be recorded at fair value, when a decline in the value of an asset not carried on the financial statements at fair value warrants an impairment write-down or valuation reserve to be established, or when an asset or liability needs to be recorded contingent upon a future event. Carrying assets and liabilities at fair value inherently results in more financial statement volatility. The fair

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values and the information used to record valuation adjustments for certain assets and liabilities are based either on quoted market prices or are provided by other third-party sources, when available. When third-party information is not available, valuation adjustments are estimated in good faith by management primarily through the use of internal cash flow modeling techniques.

Based on the valuation techniques used and the sensitivity of financial statement amounts to the methods, assumptions and estimates underlying those amounts, management has identified the determination of the allowance for loan and lease losses and valuation of goodwill to be the accounting areas that require the most subjective or complex judgments, and as such, could be most subject to revision as new information becomes available.

Allowance for Loan and Lease Losses

The allowance for loan and lease losses represents management's estimate of probable losses in the Bank's loan and lease portfolio. Determining the amount of the allowance for loan and lease losses is considered a critical accounting estimate because it requires significant judgment on the part of management and the use of estimates related to the amount and timing of expected future cash flows on impaired loans and leases, estimated losses on pools of homogeneous loans and leases based on historical loss experience and consideration of current economic trends and conditions, all of which may be susceptible to significant change. The loan portfolio also represents the largest asset type on the Company's consolidated balance sheets.

On a quarterly basis, management of the Bank meets to review and determine the adequacy of the allowance for loan and lease losses. In making this determination, the Bank's management analyzes the ultimate collectability of the loans and leases in its portfolio by incorporating feedback provided by the Bank's internal loan and lease staff, an independent internal loan and lease review function and information provided by examinations performed by regulatory agencies.

The analysis of the allowance for loan and lease losses is composed of two components: specific credit allocation and general portfolio allocation. The specific credit allocation includes a detailed review of each impaired loan and allocation is made based on this analysis. Factors may include the appraisal value of the collateral, the age of the appraisal, the type of collateral, the performance of the loan to date, the performance of the borrower's business based on financial statements, and legal judgments involving the borrower. The Company has an appraisal policy in which appraisals are obtained upon a loan being downgraded on the Company's internal loan rating scale to a 5 (special mention) or a 6 (substandard) depending on the amount of the loan, the type of loan and the type of collateral. All impaired loans are either graded a 6 or 7 on the internal loan rating scale. Subsequent to the downgrade, if the loan remains outstanding and impaired for at least one year more, management may require another follow-up appraisal. Between receipts of updated appraisals, if necessary, management may perform an internal valuation based on any known changing conditions in the marketplace such as sales of similar properties, a change in the condition of the collateral, or feedback from local appraisers. The general portfolio allocation consists of an assigned reserve percentage based on the historical loss experience and other quantitative and qualitative factors of the loan or lease category.

The general portfolio allocation is segmented into pools of loans with similar characteristics. Separate pools of loans include loans pooled by loan grade and by portfolio segment. Loans graded a 5 or worse ("criticized loans") that exceed a material balance threshold are evaluated by the Company's credit department to determine if the collateral for the loan is worth less than the loan. All of these "shortfalls" are added together and divided by the respective loan pool to calculate the quantitative factor applied to the respective pool as this represents a potential loss exposure. These loans are not considered individually impaired because the cash flow of the customer and the payment history of the loan suggest that it is not probable that the Company will be unable to collect the full amount of principal and interest as contracted and are thus still accruing interest.

Loans that are graded 4 or better ("non-criticized loans") are reserved in separate loan pools in the general portfolio allocation. A weighted average 5-year historical charge-off ratio by portfolio segment is calculated and applied against these loan pools.

For both the criticized and non-criticized loan pools in the general portfolio allocation, additional qualitative factors are applied. The qualitative factors applied to the general portfolio allocation reflect management's evaluation of various conditions. The conditions evaluated include the following: industry and regional conditions; seasoning of the loan and lease portfolio and changes in the composition of and growth in the loan and lease portfolio; the strength and duration of the business cycle; existing general economic and business conditions in the lending areas; credit quality trends in non-accruing loans and leases; timing of the identification of downgrades; historical loan and lease charge-off experience; and the results of bank regulatory examinations. Due to the nature of the loans, the criticized loan pools carry significantly higher qualitative factors than the non-criticized pools.

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Direct financing leases are segregated from the rest of the loan portfolio in determining the appropriate allowance for that portfolio segment. The Company performs a migration analysis for non-accruing leases based on historical loss data. Management periodically updates this analysis by examining the non-accruing lease portfolio at different points in time and studying what percentage of the non-accruing portfolio ends up being charged off. All of the remaining leases not in non-accrual are allocated a reserve based on several factors including: delinquency and non-accrual trends, charge-off trends, and national economic conditions.

For further discussion on the allowance for loan and lease losses, please see Note 1 and Note 3 to the Consolidated Financial Statements included in Item 8 of this Annual Report on Form 10-K.

Goodwill and Intangible Assets

The amount of goodwill reflected in the Company's Consolidated Financial Statements is required to be tested by management for impairment on at least an annual basis. The test for impairment of goodwill in an identified reporting unit is considered a critical accounting estimate because it requires judgment on the part of management and the use of estimates related to the growth assumptions and market multiples used in the valuation model. As of December 31, 2012, TEA had $8.1 million in goodwill. The banking and ENL reporting units do not have any goodwill. All of the goodwill at TEA stems from the acquisition of various insurances agencies, not the purchase of diverse companies in which goodwill was subjectively allocated to different reporting units. Therefore, total market capitalization reconciliation was not performed because not all of the reporting units had goodwill. As a result, such an analysis would not be meaningful.

Management valued TEA, the reporting unit with goodwill, using cash flow modeling and earnings multiple techniques. When using the cash flow models, management considered historical information, the operating budget for 2013, economic and insurance market cycles, and strategic goals in projecting net income and cash flows for the next five years. The fair value calculated substantially exceeded the book value of TEA. The value based on a multiple to earnings before interest, taxes, depreciation, and amortization ("EBITDA") was higher, a result of conservative growth assumptions used by the Company in the cash flow model as well as an implied control premium in the multiple. The multiple used was based on historical industry data and consistent with the previous year's assumption.

While the fair values determined in the impairment tests were substantially higher than the carrying value for TEA, the risk of a future impairment charge still exists. Management used growth rates that are achievable over the long run through both soft and hard insurance cycles. A soft insurance market has persisted for several years, resulting in a slight increase in revenue of 0.9% in 2012 compared with 2011. A worsening of the soft insurance market over the long term could result in lower than projected revenue and profitability growth rates and result in depressed pricing multiples in the acquisition marketplace. Further softening of the insurance market is the biggest risk to the Company's valuation model.

For further discussion of the Company's accounting for goodwill and other intangible assets, see Note 1 to the Consolidated Financial Statements included in Item 8 of this Annual Report on Form 10-K.

RECENT ACCOUNTING PRONOUNCEMENTS AND DEVELOPMENTS

Note 1 to the Company's Consolidated Financial Statements included in Item 8 of this Annual Report on Form 10-K discusses new accounting policies adopted by the Company during fiscal 2012. Below is an accounting policy recently issued or proposed but not yet required to be adopted. To the extent management believes the adoption of new accounting standards materially affects the Company's financial condition, results of operations, or liquidity, the impacts are discussed below.

Accounting Standards Update ("ASU") 2012-06, Subsequent Accounting for an Indemnification Asset Recognized at the Acquisition Date as a Result of a Government-Assisted Acquisition of a Financial Institution.   Accounting for a business combination requires that at each subsequent reporting date, an acquirer measure an indemnification asset on the same basis as the indemnified liability or asset, subject to any contractual limitations on its amount, and, for an indemnification asset that is not subsequently measured at its fair value, management's assessment of the collectibility of the indemnification asset. The objective of this ASU is to address the diversity in practice about how to interpret the terms on the same basis and contractual limitations when subsequently measuring an indemnification asset recognized in a government-assisted (Federal Deposit Insurance Corporation) acquisition of a financial institution that includes a loss-sharing agreement (indemnification agreement). The new guidance is effective for interim and annual periods beginning after December 15, 2012. The Company will adopt this ASU effective January 1, 2013, and is currently addressing the impact on the Company's accounting, which is not expected to be material. The Company does have an indemnification agreement with the FDIC related to its acquisition of Waterford Village Bank ("Waterford") in July 2009. The agreement ends for non-single family loans in July 2014 and for single family loans in July 2019.

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RESULTS OF OPERATIONS FOR THE YEARS ENDED DECEMBER 31, 2012 AND DECEMBER 31, 2011

Net Income

Net income of $8.1 million in 2012 consisted of $7.0 million related to the Company's banking activities and $1.1 million in net income related to the Company's insurance agency activities. The total net income of $8.1 million was an increase of 32.8% from $6.1 million in 2011. Earnings per diluted share for 2012 of $1.95 were an increase of 30.9% from $1.49 per diluted share for 2011.

Net Interest Income

Net interest income, the difference between interest income and fee income on earning assets, such as loans and securities, and interest expense on deposits and borrowings, provides the primary basis for the Company's results of operations.

Net interest income is dependent on the amounts and yields earned on interest earning assets as compared to the amounts of and rates paid on interest bearing liabilities.

AVERAGE BALANCE SHEET INFORMATION

The following table presents the significant categories of the assets and liabilities of the Bank, interest income and interest expense, and the corresponding yields earned and rates paid in 2012, 2011 and 2010. The assets and liabilities are presented as daily averages. The average loan balances include both performing and non-performing loans. Interest income on loans does not include interest on loans for which the Bank has ceased to accrue interest. Securities are stated at fair value. Interest and yield are not presented on a tax-equivalent basis.

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	2012			2011			2010		
	Average Balance	Interest	Yield/ Rate	Average Balance	Interest	Yield/ Rate	Average Balance	Interest	Yield/ Rate
	(dollars in thousands)								
Assets									
Interest-earning assets:									
Loans and leases, net	$ 579,586	$ 30,300	5.23%	$ 535,526	$ 29,140	5.44%	$ 494,366	$ 28,102	5.68%
Taxable securities	67,679	1,870	2.76%	62,269	2,115	3.40%	50,149	1,740	3.47%
Tax-exempt securities	34,104	1,153	3.38%	37,201	1,434	3.85%	39,330	1,566	3.98%
Federal funds sold	42,817	53	0.12%	16,395	26	0.16%	4,642	9	0.19%
Total interest-earning assets	724,186	33,376	4.61%	651,391	32,715	5.02%	588,487	31,417	5.34%
Non interest-earning assets:									
Cash and due from banks	11,634			14,223			13,281		
Premises and equipment, net	10,748			10,607			10,054		
Other assets	36,009			35,760			35,059		
Total Assets	$ 782,577			$ 711,981			$ 646,881		
Liabilities & Stockholders' Equity									
Interest-bearing liabilities:									
NOW	$ 59,811	615	1.03%	$ 44,639	548	1.23%	$ 24,981	251	1.00%
Regular savings deposits	341,739	1,931	0.57%	280,606	2,019	0.72%	237,939	1,648	0.69%
Muni-vest savings	24,937	79	0.32%	27,272	131	0.48%	30,005	145	0.48%
Time deposits	109,508	1,921	1.75%	131,171	2,923	2.23%	142,360	3,616	2.54%
Other borrowed funds	20,161	681	3.38%	23,287	760	3.26%	31,721	909	2.87%
Junior subordinated debentures	11,331	348	3.07%	11,330	331	2.92%	11,330	333	2.94%
Securities sold under agreement to repurchase	10,009	22	0.22%	6,679	15	0.22%	7,531	20	0.27%
	577,496	5,597	0.97%	524,984	6,727	1.28%	485,867	6,922	1.42%

Total interest-bearing liabilities						
Non interest-bearing liabilities:						
Demand deposits	119,805		108,522		92,072	
Other	12,381		11,829		11,006	
Total liabilities	709,682		645,335		588,945	
Stockholders’ equity	72,895		66,646		57,936	
Total Liabilities & Equity	$ 782,577		$ 711,981		$ 646,881	
Net interest income		$ 27,779		$ 25,988		$ 24,495
Net interest margin		3.84%		3.99%		4.16%
Interest rate spread		3.64%		3.74%		3.92%

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The following table segregates changes in interest earned and paid for the past two years into amounts attributable to changes in volume and changes in rates by major categories of assets and liabilities. The change in interest income and expense due to both volume and rate has been allocated in the table to volume and rate changes in proportion to the relationship of the absolute dollar amounts of the change in each.

	2012 Compared to 2011 Increase (Decrease) Due to (in thousands)			2011 Compared to 2010 Increase (Decrease) Due to		
	Volume	Rate	Total	Volume	Rate	Total
Interest earned on:						
Loans	$ 2,331	($1,171)	$ 1,160	$ 2,274	($1,236)	$ 1,038
Taxable securities	171	(416)	(245)	412	(37)	375
Tax-exempt securities	(113)	(168)	(281)	(83)	(49)	(132)
Federal funds sold	34	(6)	28	19	(2)	17
Total interest-earning assets	$ 2,423	($1,761)	$ 662	$ 2,622	($1,324)	$ 1,298
Interest paid on:						
NOW accounts	$ 166	($99)	$ 67	$ 232	$ 65	$ 297
Savings deposits	395	(483)	(88)	305	66	371
Muni-vest	(11)	(41)	(52)	(13)	(1)	(14)
Time deposits	(438)	(564)	(1,002)	(271)	(422)	(693)
Fed funds purchased & other borrowings	3	(58)	(55)	(244)	88	(156)
Total interest-bearing liabilities	$ 115	($1,245)	($1,130)	$ 9	($204)	($195)

Net interest income increased by $1.8 million, or 6.9%, to $27.8 million in 2012 from $26.0 million in 2011. As indicated in the preceding table, interest-earning asset and interest-bearing liability volume positively impacted net interest income by $2.3 million, while rates earned and paid on those respective assets and liabilities negatively impacted net interest income by $0.5 million. Overall, the increase in the volume of loans and the benefit of lower rates paid on deposits was partially offset by lower rates earned on interest-earning assets, particularly loans and leases.

The FRB has executed on a monetary policy designed to keep interest rates at all time lows for the past four years. The target overnight rate has been between 0.00% and 0.25% since the end of 2008. The FRB has also executed on other quantitative easing strategies, including the purchase of mortgage-backed securities, in an attempt to depress longer-term market interest rates. Although these policies have raised concerns from some observers about future inflation, the slow-growing global economy and generally pessimistic expectations for future growth have kept longer-term rates relatively low through 2012. This interest rate environment resulted in lower interest yields earned on assets as well as lower rates paid on liabilities. Assets continue to re-price into lower yields as older loans and securities mature and new loans are originated and securities purchased at much lower yields than those they are replacing.

The Company has invested in adding to its commercial loan portfolio significantly in the past two to three years by adding several commercial loan officers while existing loan officers have successfully increased production. Total commercial loan portfolio balance, including commercial real estate and commercial and industrial loans, increased by 10.2%, from a $417.5 million average balance in 2011 to a $460.2 million average balance in 2012. Consumer loans increased 1.2% from $128.5 million average balance in 2011 to $130.0 million in 2012.

On the funding side, the Company has been successful in attracting new deposit customers, with most of that success coming in the premium-rate Better Checking, Better Savings, and business money market accounts. These products have begun to mature in their product life cycle and competitors have reduced rates on virtually all deposit products, creating an opportunity for the Company to reduce rates on these products while remaining competitive and retaining core customers. Due to customer preference for liquid deposits with long-term rates at all-time lows, time deposit balances decreased in 2012 as demand for the product remained weak. Also, as time deposits roll off, they have been replaced by lower rate deposits due to the low interest rate environment.

Net interest spread, or the difference between yield on interest-earning assets and rate on interest-bearing liabilities, declined to 3.64% in 2012, compared with 3.74% in 2011. The yield on interest-earning assets decreased 41 basis points from 5.02% in 2011 to 4.61% in 2012, and the cost of interest-bearing liabilities decreased 31 basis points, from 1.28% in 2011 to 0.97% in 2012. Net interest spread shrank as the yield curve, or the difference between long-term rates and short-term rates, flattened throughout 2012. Banks traditionally benefit from a steep yield curve because the duration of interest-earnings assets is typically longer than the duration of interest-bearing liabilities. In addition, the Company's opportunities to re-price on the liability side have not been enough to make up for the steeper decrease in asset yields from re-pricing.

The Company's net interest margin decreased from 3.99% in 2011 to 3.84% in 2012, reflecting the changes to the net interest spread. It should be noted that several factors could put additional pressure on the Company's net interest margin in the future, including further flattening of the yield curve and increased pricing competition for loans and deposits.

The Bank regularly monitors its exposure to interest rate risk. Management believes that the proper management of interest-sensitive funds will help protect the Bank's earnings against changes in interest rates. The Bank's Asset/Liability Management Committee ("ALCO") meets monthly for the purpose of evaluating the Bank's short-term and long-term liquidity position and the potential impact on capital and earnings of changes in interest rates. The Bank has adopted an asset/liability policy that specifies minimum limits for liquidity and capital ratios. This policy includes setting ranges for the negative impact acceptable on net interest income and on the fair value of equity as a result of a shift in interest rates. The asset/liability policy also includes guidelines for investment activities and funds management. At its monthly meetings, ALCO reviews the Bank's status and formulates its strategies based on current economic conditions, interest rate forecasts, loan demand, deposit volatility and the Bank's earnings objectives.

Provision for Loan and Lease Losses

The Company's provision for loan and lease losses decreased $2.6 million from $2.5 million in 2011 to ($0.1) million in 2012. The overall decrease was a result of a decline in the provision for loan losses of $2.1 million from $3.0 million in 2011 to $0.9 million in 2012, combined with a larger negative provision of $0.9 million for the leasing portfolio in 2012, compared with a negative provision for lease losses of $0.5 million in 2011. The decrease in the provision for loan losses in 2012 stemmed mostly from a low growth rate in the loan portfolio, lower levels of criticized loans, and recoveries of previous charge-offs, offset somewhat by the increase in specific reserves on several impaired loan relationships and an increase in historical loss factors. Loan recoveries increased from $0.1 million in 2011 to $0.2 million in 2012. As noted in Note 3 to the Consolidated Financial Statements included in Item 8 of this Annual Report on Form 10-K, the Company reserves a higher percentage on loans risk rated 5 or higher. The

Company had $20.2 million in loans risk rated 5 or higher at December 31, 2012, compared with $23.5 million at December 31, 2011. Loan growth, not including leases, was $3.9 million in 2012, compared with $64.9 million in 2011, resulting in a significantly lower provision for loan growth in 2012. There were five commercial loans that were either already impaired at December 31, 2011 and deteriorated, or became impaired in 2012 and required a specific reserve. The net charge-off ratio increased from 0.26% in 2011 to 0.29% in 2012, resulting in an increase in the Company's historical loss factors. The negative provision for leasing was higher in 2012 as the portfolio continued to wind down with non-accruing leases and charge-offs declining significantly, justifying a continued release of reserves.

The ratio of non-performing loans and leases to total loans and leases declined significantly from 2.64% at December 31, 2010 and 2.60% at December 31, 2011 to 1.41% at December 31, 2012. Trends in non-performing loans and charge-offs are good indicators of credit quality and provide context for the movement in the provision for loan and lease losses, and are presented and discussed in the next section. A description of how the allowance for loan and lease losses is determined along with tabular data depicting the key factors in calculating the allowance is set forth in Notes 1 and 3 of the Notes to Consolidated Financial Statements included in Part II, Item 8 of this Annual Report on Form 10-K.

Non-accrual, Past Due and Restructured Loans and Leases

The following table summarizes the Bank's non-accrual and accruing loans and leases 90 days or more past due as of the dates listed below. See Note 3 of the Notes to Consolidated Financial Statements included in Part II, Item 8 of this Annual Report on Form 10-K for further information about the Company's non-accrual, past due and restructured loans and leases.

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	At December 31, 2012	2011	2010	2009	2008
	(in thousands)				
Non-accruing loans and leases:					
Mortgage loans on real estate:					
Residential mortgages	$ 1,443	$ 1,048	$ 742	$ 978	$ -
Commercial and multi-family	4,309	6,858	5,724	2,328	1,291
Construction-residential	-	167	186	-	-
Construction-commercial	729	1,442	850	417	417
Home equities	618	946	256	181	51
Total mortgage loans on real estate	7,099	10,461	7,758	3,904	1,759
Direct financing leases	171	1,160	2,930	2,905	791
Commercial and industrial loans	914	2,180	2,203	1,784	758
Consumer installment loans	44	76	230	243	-
Other	-	-	-	-	123
Total non-accruing loans and leases	$ 8,228	$ 13,877	$ 13,121	$ 8,836	$ 3,431
Accruing loans and leases 90+ days past due	-	1,299	806	4,112	148
Total non-performing loans and leases	$ 8,228	$ 15,176	$ 13,927	$ 12,948	$ 3,579
Total non-performing loans and leases to total assets	1.02%	2.05%	2.07%	2.09%	0.68%
Total non-performing loans and leases to total loans and leases	1.41%	2.60%	2.64%	2.64%	0.88%

Non-performing loans and leases decreased $7.0 million from $15.2 million at December 31, 2011 to $8.2 million at December 31, 2012. At December 31, 2011, there were two commercial construction loans classified as 90 days past due and still accruing. Both loans were in the process of being extended, but past their original maturity date. As of December 31, 2012, there were no loans more than 90 days past due and still accruing, accounting for a $1.3 million decrease in non-performing loans and leases.

Non-accruing loans and leases decreased $5.7 million from $13.9 million at December 31, 2011 to $8.2 million at December 31, 2012. The largest portion of non-accruing loans and leases remains the commercial real estate portfolio (classified in the preceding table as commercial and multi-family real estate and construction-commercial). However, the balance of non-accruing loans in that category decreased from $8.3 million at December 31, 2011 to $5.0 million at December 31, 2012. Only one commercial real estate loan relationship, totaling $0.1 million, entered into non-accruing status in 2012. On the other hand, $1.6 million paid off, $0.8 million charged off, and $0.7 million returned to accruing status. There was an additional $0.3 million reduction from non-accruing loans that were paid down during 2012.

Non-accruing consumer real estate loans, including residential mortgages and home equity loans and lines of credit, increased slightly in 2012, from $2.0 million at December 31, 2011 to $2.1 million at December 31, 2012. $0.6 million of the $2.1 million are from the former Waterford loan portfolio purchased from the FDIC in 2009. Historical losses in these portfolios have been relatively low as the Company has typically loaned at conservative loan-to-value ratios, resulting in less losses.

The next largest segment of non-accruing loans and leases are the C&I loans, which dropped from $2.2 million at December 31, 2011 to $0.9 million at December 31, 2012. There are three loans in non-accruing status worth $0.2 million at December 31, 2012 that were still accruing as of the previous year-end. $0.6 million of last year’s C&I non-accruing balance charged off in 2012 while $0.9 million of the balance was paid down or paid off.

Non-accruing leases decreased from $1.2 million at December 31, 2011 to $0.2 million at December 31, 2012. The Company discontinued direct financing lease originations in April 2009 and plans to service the portfolio to maturity. Similar to 2011, the charge-offs and pay-downs of non-accruing leases in 2012 exceeded the amount of leases going into non-accruing status, resulting in the decrease in the non-accruing lease balance.

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The former Waterford loans are covered by a loss sharing agreement with the FDIC, under which the FDIC agreed to bear 80% of loan and foreclosed real estate losses up to $5.6 million and 95% of losses beyond $5.6 million. The former Waterford loans will be referred to as covered loans in this document because they are "covered" by the FDIC guarantee. The Company has incurred $1.2 million in losses on the covered portfolio through December 31, 2012, with the FDIC bearing 80% of those losses.

The Company had $11.5 million in loans and leases that were restructured and deemed to be a troubled debt restructuring ("TDR") at December 31, 2012 with $6.0 million of those balances in non-accrual status. Any TDR that is placed on non-accrual is not reverted back to accruing status until the borrower makes timely payments as contracted for at least six months and future collection under the revised terms is probable. One residential mortgage loan for $0.5 million was made under a government assistance program in the third quarter of 2012. Six loans totaling $1.2 million are covered under the loss-sharing arrangement with the FDIC cited above. All of the restructurings were allowed in an effort to maximize the Company's ability to collect on loans and leases where borrowers were experiencing financial difficulty. Modifications made to loans in a troubled debt restructuring did not have a material impact on the Company's net income for the years ended December 31, 2012 and 2011. The reserve for a TDR is based upon the present value of the future expected cash flows discounted at the loan's original effective rate or upon the fair value of the collateral less costs to sell, if the loan is deemed collateral dependent. This reserve methodology is used because all TDR loans are considered impaired.

The following table presents the Company's TDR loans and leases as of December 31, 2012:

	December 31, 2012			
	($ in thousands)			
	Total	Nonaccruing	Accruing	Related Allowance
	$	$	$	$
Commercial and industrial	2,592	720	1,872	335
Residential real estate:				
Residential	509	509	-	-
Construction	-	-	-	-
Commercial real estate:				
Commercial and multi family	6,203	3,958	2,245	471
Construction	1,663	729	934	0
Home equities	320	-	320	-
Direct financing leases	164	70	94	13
Consumer loans	-	-	-	-

Other	-	-	-	-
Total troubled restructured loans and leases	$ 11,451	$ 5,986	$ 5,465	$ 819

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Allowance for Loan and Lease Losses

The following table summarizes the Bank's allowance for loan and lease losses and changes in the allowance for loan and lease losses by categories:

ANALYSIS OF THE ALLOWANCE FOR LOAN AND LEASE LOSSES

	2012	2011	2010	2009	2008
	(in thousands)				
BALANCE AT THE BEGINNING OF THE YEAR	$ 11,495	$ 10,424	$ 6,971	$ 6,087	$ 4,555
CHARGE-OFFS:					
Residential mortgages	(12)	-	-	-	-
Commercial and multi-family	(900)	(189)	-	-	-
Construction-residential	-	-	-	-	-
Construction-commercial	-	-	(104)	-	-
Home equities	(114)	-	-	(34)	(1)
Direct financing leases	-	-	-	(9,483)	(2,149)
Commercial loans	(862)	(1,305)	(388)	(285)	-
Consumer loans	(32)	(2)	(4)	-	(2)
Other	-	(26)	(53)	(56)	(53)
TOTAL CHARGE-OFFS	(1,920)	(1,522)	(549)	(9,858)	(2,205)
RECOVERIES:					
Residential mortgages	1	-	-	-	-
Commercial and multi-family	15	57	-	-	-
Construction-residential	-	-	-	-	-
Construction-commercial	-	-	30	-	-
Home equities	6	2	1	-	-
Direct financing leases	-	-	-	211	170
Commercial loans	184	39	4	9	36
Consumer loans	19	1	-	-	2
Other	-	10	24	22	21
TOTAL RECOVERIES	225	109	59	242	229
NET CHARGE-OFFS	(1,695)	(1,413)	(490)	(9,616)	(1,976)
PROVISION FOR LOAN AND LEASE LOSSES	(68)	2,484	3,943	10,500	3,508

BALANCE AT END OF YEAR	$ 9,732	$ 11,495	$ 10,424	$ 6,971	$ 6,087
RATIO OF NET CHARGE-OFFS TO AVERAGE NET LOANS AND LEASES OUTSTANDING	0.29%	0.26%	0.10%	2.19%	0.55%
RATIO OF ALLOWANCE FOR LOAN AND LEASE LOSSES TO TOTAL LOANS AND LEASES	1.67%	1.97%	1.97%	1.42%	1.49%

Net charge-offs increased from $1.4 million in 2011 to $1.7 million in 2012. The ratio of net charge-offs to average net loans and leases outstanding increased from 0.26% to 0.29%. The largest increase occurred in the commercial and multi-family real estate loans. $0.8 million of the $0.9 million in charge-offs in 2012 were related to two loans, one in retail and the other a golf course. While net charge-offs did increase in 2012, the net charge-off ratio remains low when compared with other banks of a similar size industry-wide.

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An allocation of the allowance for loan and lease losses by portfolio type over the past five years follows (dollars in thousands):

	Balance at 12/31/2012 Attributable to:	Percent of loans in each category to total loans:	Balance at 12/31/2011 Attributable to:	Percent of loans in each category to total loans:	Balance at 12/31/2010 Attributable to:	Percent of loans in each category to total loans
Residential Mortgages*	$ 662	11.84%	$ 793	13.00%	$ 548	13.50%
Commercial Mortgages*	4,493	60.58%	4,670	57.30%	4,252	55.60%
Home Equities	746	9.68%	768	9.40%	540	10.10%
Commercial Loans	3,617	17.17%	4,085	18.80%	3,435	17.30%
Consumer Loans**	18	0.45%	36	0.50%	29	0.60%
Direct financing leases	47	0.28%	994	1.00%	1,471	2.90%
Unallocated	149	-%	149	-%	149	-%
Total	$ 9,732	100.00%	$ 11,495	100.00%	$ 10,424	100.00%

* includes construction loans
** includes other loans

Allowance for C&I loans comprises 37.2% of the allowance for loan and lease losses despite being only 17.2% of the loan and lease portfolio, while the allowance related to commercial mortgages comprises 46.2% of the allowance for loan and lease losses despite being 60.6% of the total loan and lease portfolio. Over the past five years, C&I loans have suffered far higher losses than the commercial mortgage portfolio, despite the higher losses in the commercial mortgage portfolio in 2012.

The troubled economy resulted in a significant increase in net charge-offs in the direct financing lease portfolio during 2009. The $9.3 million in net leasing charge-offs included a mark-to-market adjustment of $7.2 million on the total portfolio after the Company initially announced its intention to sell the portfolio during the second quarter of 2009. The fair value calculation was based on competitive bids. Subsequent to that initial announcement, the Company decided to keep and service the remaining leasing portfolio until maturity rather than sell the portfolio at a distressed value in a difficult market. Under GAAP, the Company did not reverse the mark-to-market adjustment made at June 30, 2009, even though it no longer intended to sell the portfolio. The adjustment initially represented the difference between the leasing portfolio's principal value and fair value. Although leases are not valued at fair value any longer as the Company no longer intends to sell the portfolio, there remains a difference between the principal value and carrying value. As leases are deemed uncollectible, the principal value is written down and the difference between the principal value and the carrying value becomes smaller. The following table illustrates the charge-off activity in the leasing portfolio along with some relevant credit quality data:

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	As of December 31,		
	2012	2011	2010
Direct financing lease principal balance	$ 1,742	$ 6,509	$ 16,968
Mark-to-market adjustment	(130)	(488)	(1,493)
Direct financing lease carrying balance	$ 1,612	$ 6,021	$ 15,475

	For the year ended December 31,		
	2012	2011	2010
Beginning balance of mark	$ 488	$ 1,493	$ 4,159
Mark-to-market adjustment	-	-	-
Net write-offs	(358)	(1,005)	(2,666)
Remaining mark	$ 130	$ 488	$ 1,493
Allowance for lease losses, beginning balance	$ 994	$ 1,471	$ -
(Reduction of) provision for lease losses	(947)	(477)	1,471
Leasing net charge-offs	-	-	-
Allowance for lease losses, ending balance	$ 47	$ 994	$ 1,471
Total mark plus allowance	$ 177	$ 1,482	$ 2,964
Mark plus allowance / leasing principal balance	10.16%	22.77%	17.47%
Non-accruing leases	$ 171	$ 1,160	$ 2,930
Non-accruing leases / leasing principal balance	9.82%	17.82%	17.27%

In 2010, the leasing portfolio continued to deteriorate as non-accruing leases increased slightly, despite the overall principal balance of the portfolio declining by 52.4%, resulting in an increase in the non-accruing lease ratio from 8.15% at December 31, 2009 to 17.27% at December 31, 2010. The apparent deterioration in the portfolio resulted in management provisioning for $1.5 million in additional lease losses. In 2011, performance in the portfolio improved with non-accruing leases declining 60.4% as the portfolio continued to roll off. Consequently, the non-accruing lease ratio stabilized at 17.82% at December 31, 2011, compared with 17.27% at December 31, 2010. Also, net write-offs slowed in 2011 at $1.0 million compared with $2.7 million in 2010. This caused the mark plus allowance ratio to improve from 17.47% at December 31, 2010 to 22.77% at December 31, 2011. The combined impact of the reduced non-accruing leases and net lease write-offs was a sharp increase in the coverage of the mark plus allowance compared with non-accruing leases. The improved credit quality metrics in 2011 resulted in management releasing allowance of $0.5 million. There was continued improvement in the portfolio in 2012 as non-accruing leases declined to $0.2 million at December 31, 2012 from $1.2 million at December 31, 2011. The par value of the leasing portfolio is down to $1.6 million as of December 31, 2012. With an increasingly low level of non-accruing leases and the portfolio nearing the end of its life, management reduced the allowance for lease losses by an additional $0.9 million. Despite the reduction of leasing allowance, the mark plus allowance ratio remains higher than the non-accruing leases to total leases ratio.

Overall, the ratio of the allowance for loan and lease losses to total loan and leases declined from 1.97% on December 31, 2011 to 1.67% at December 31, 2012. This is a reflection of the improving credit quality of the loan and lease portfolio, as evidenced by the decline in the ratio of non-performing loans and leases to total loans and leases from 2.60% at December 31, 2011 to 1.41% at December 31, 2012. Therefore, despite the decrease in the ratio of the allowance for loan and lease losses to total loans and leases, the coverage ratio of the allowance for loan and lease losses to non-performing loans and leases increased significantly from 76% to 118%. There are two other factors that significantly influence these ratios.

The first factor is the acquisition of Waterford's loan portfolio. At December 31, 2012, the Company had $20.8 million in loans from the acquisition that are covered under the loss share agreement with the FDIC. Under the agreement, the Company is eligible to be reimbursed for 80% of the losses up to $5.6 million, and 95% of losses above $5.6 million, based on the acquired loans' original carrying value. At the time of acquisition, the Company wrote down any impaired loans to fair value. The $2.0 million in impaired loans and $0.2 million in other real estate were written down by $1.4 million, to a net carrying value of $0.8 million. These loans were immediately put on non-accruing status. These loans currently have a carrying value of less than $0.1 million. $1.9 million in loans acquired from Waterford were in non-accruing status as of December 31, 2012. Because of the 80% guarantee provided by the FDIC, the amount of the

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allowance for loan losses on this $20.8 million loan portfolio is only $0.1 million, or 0.57% of the acquired loan portfolio.

The second factor is the direct financing lease portfolio. Due to the significant credit issues in this portfolio, the leasing portfolio carries a higher allowance ratio than the rest of the portfolio. The coverage ratio of 28.1% is lower than the legacy loan portfolio. However, this lower ratio is mitigated by the remaining mark on the portfolio as discussed and shown in the previous table. The following table depicts the allowance and non-performing ratios by segregating the legacy loan portfolio, the purchased loan portfolio that is partially guaranteed by the FDIC and the leasing portfolio as of December 31, 2012 and 2011, respectively:

December 31, 2012

($ in thousands)	Balance	Allowance for loans and leases	Non-performing loan and lease losses	Allowance for loan and lease losses/Total loans and leases	Non-performing loans/Total loans and leases	Allowance for loan and lease losses/ Non-performing loans
Legacy portfolio	$ 560,496	$ 9,566	$ 6,207	1.71%	1.11%	154.12%
Acquired loans	20,787	119	1,850	0.57%	8.90%	6.43%
Leases	1,612	47	171	2.92%	10.61%	27.49%
Total	$ 582,895	$ 9,732	$ 8,228	1.67%	1.41%	118.28%

December 31, 2011

($ in thousands)	Balance	Allowance for loans and leases	Non-performing loan and lease losses	Allowance for loan and lease losses/Total loans and leases	Non-performing loans/Total loans and leases	Allowance for loan and lease losses/ Non-performing loans
Legacy portfolio	$ 552,346	$ 10,400	$ 11,488	1.88%	2.08%	90.53%
Acquired loans	25,038	101	2,528	0.40%	10.10%	4.00%
Leases	6,021	994	1,160	16.51%	19.27%	85.69%
Total	$ 583,405	$ 11,495	$ 15,176	1.97%	2.60%	75.74%

The Company maintains a robust loan review process to ensure that specific credits are appropriately reserved. In particular, management continues to monitor the leasing portfolio closely in a more challenging economic environment. Also, management is cognizant that commercial real estate values may be more susceptible to decline than other types of loans in an adverse economy. Management believes that the allowance for loan and lease losses is reflective of a fair assessment of the current environment and credit quality trends.

Non-Interest Income

Total non-interest income increased $0.4 million, or 3.2%, from 2011 to 2012. The primary factor driving the increase was the gain on loans sold to Fannie Mae, which rose $0.3 million. The Company was able to achieve higher than usual gains per mortgage sold due to historically low rates offered by Fannie Mae. The Company was able to maintain its competitive position in the marketplace while achieving more discipline in its mortgage pricing. In addition, insurance service and fee revenue increased $0.1 million, or 0.9%, to $7.0 million. TEA's revenue is the largest component of non-interest income at 54.3% of total non-interest income. TEA remains a source of diversification in the earnings of the Company and helps generate income not directly impacted by difficult credit or interest rate environments. However, during 2012, TEA revenue growth continued to remain relatively flat due to the soft insurance market. Deposit service charges increased $0.1 million, or 4.2%, from prior year, to $1.9 million. This is attributable to the Company increasing fee revenue on commercial checking accounts. These increases were somewhat offset by a decrease in data center revenue of $0.2 million. Data center income is from the Bank's wholly-owned subsidiary, Suchak Data Systems, LLC ("SDS"). SDS is a data processing company which was acquired by the Bank on December 31, 2008. The original contracted revenue generated by service agreements with other banks is expiring as expected. The Company is focusing on the original purpose for the purchase of SDS, which was to provide resources for its own internal bank processing needs.

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Non-Interest Expense

Total non-interest expense increased $1.6 million, or 5.7%, from $27.2 million in 2011 to $28.8 million in 2012. The largest increase in non-interest expense was in salaries and employee benefits, which increased $1.5 million, or 9.4%, in comparison to 2011. The increase stems from merit increases, increased incentive pay, pension and supplemental executive retirement plan expenses, and increased health care costs.

Professional service expenses increased $0.1 million, or 8.4%, to $1.9 million in 2012. Most of the increase is attributable to increased legal expenses related to non-performing loans. While non-performing loans as a percentage of total loans and leases actually decreased over the past two years, there are two large commercial loan relationships that caused the company to incur significant legal expenses in 2012.

Technology and communications expense increased $0.2 million, or 21.8%, to $1.2 million in 2012. The increase is entirely attributable to an increase in ATM and debit card processing fees paid by the Company as customer usage of ATM and debit cards continues to rise.

Other non-interest expenses also increased $0.2 million, or 7.9%. Various items drove this increase, including increased charitable contributions ($0.1 million), increased fraud losses on debit cards ($0.1 million), and increased ATM fee rebate costs associated with the Company's Better Checking product.

These increases were somewhat offset by decreases in occupancy expenses, FDIC insurance premiums and intangible amortization expense. Occupancy expenses decreased $0.3 million, or 10.7%, due to efficiencies achieved in the consolidation of several TEA insurance offices and the run-off of fully depreciated fixed assets.

After a significant increase in FDIC insurance premiums in 2009 and 2010, the Company benefited from the change in calculation of the assessment base stipulated by the Dodd-Frank Act in mid-2011. The change in the calculation resulted in a decrease in FDIC insurance expense of $0.1 million to $0.5 million in 2012 as a result of the effect of the full year of decreased premiums.

In 2012, the Company benefited from the expiration of the amortization of intangibles related to its purchase of an insurance agency in 2007. Amortization expense declined from $0.5 million in 2011 to $0.3 million in 2012.

The efficiency ratio expresses the relationship of operating expenses to revenues. The Company's efficiency ratio, or non-interest operating expenses (exclusive of non-cash goodwill impairment and intangible amortization) divided by the sum of net interest income and non-interest income (exclusive of gains and losses from investment securities), was 70.1% in 2012, an increase from 2011's ratio of 69.7% as a result of the Company's declining net interest margin and investments in additional employees and infrastructure.

Taxes

The provision for income taxes in 2012 was $3.7 million on pre-tax income of $11.9 million for an effective rate of 31.5%, compared with an effective rate of 29.7% in 2011. While income before taxes increased $3.2 million, the two primary sources of tax-exempt income, interest income on tax-advantaged municipal bonds and bank-owned life insurance income, declined $0.2 million, resulting in tax-exempt income being a smaller portion of total income before taxes.

RESULTS OF OPERATIONS FOR YEARS ENDED DECEMBER 31, 2011 AND DECEMBER 31, 2010

Net Income

Net income of $6.1 million in 2011 consisted of $5.2 million related to the Company's banking activities and $0.9 million in net income related to the Company's insurance agency activities. The total net income of $6.1 million was an increase of 26.3% from $4.8 million in 2010. Earnings per basic and diluted share for 2011of $1.49 was an increase of 11.1% from $1.34 per diluted share for 2010. The difference between the net income percentage increase and the earnings per share percentage increase is a result of the increase in the number of outstanding common shares, reflecting 1,125,000 shares issued pursuant to the Company's registered common stock offering in May 2010.

Net Interest Income

Net interest income increased by $1.5 million, or 6.1%, to $26.0 million in 2011 from $24.5 million in 2010. Interest-earning asset and interest-bearing liability volume positively impacted net interest income by $2.6 million, while rates

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earned and paid on those respective assets and liabilities negatively impacted net interest income by $1.1 million. Overall, the increase in the volume of loans and investment securities and the benefit of lower rates paid on time deposits was partially offset by lower rates earned on interest-earning assets, particularly loans and leases.

The total commercial loan portfolio, including commercial real estate and commercial and industrial loans, increased by 14.3%, from a $356.3 million average balance in 2010 to a $407.1 million average balance in 2011. Consumer loans increased 4.3% from $123.2 million average balance in 2010 to $128.5 million in 2011. Investment securities volume positively impacted net interest income by $0.3 million as management used the excess liquidity from the Company's strong deposit growth to purchase investments.

On the funding side, the Company was successful in attracting new deposit customers, with most of that success coming in the premium-rate Better Checking, Better Savings, and business money market accounts. While these products put some pressure on the net interest margin, the Company expects to benefit in the long term from the deeper relationships that these core deposits products provide. In order to get the premium rates, customers have to have multiple products with the Company and demonstrate its core relationship with the Bank through required transaction activity in checking accounts. Due to customer preference for liquid deposits with long-term rates at all-time lows, time deposit balances decreased in 2011 as demand for the product remained weak. Also, as time deposits roll off, they have been replaced by lower rate deposits due to the low interest rate environment.

Net interest spread, or the difference between yield on interest-earning assets and rate on interest-bearing liabilities, declined to 3.74% in 2011, compared with 3.92% in 2010. The yield on interest-earning assets decreased 32 basis points from 5.34% in 2010 to 5.02% in 2011, and the cost of interest-bearing liabilities decreased 14 basis points, from 1.42% in 2010 to 1.28 % in 2011. Net interest spread shrank as the yield curve, or the difference between long-term rates and short-term rates, flattened throughout 2011. Banks traditionally benefit from a steep yield curve because the duration of interest-earnings assets is typically longer than the duration of interest-bearing liabilities. The Company's net interest margin decreased from 4.16% in 2010 to 3.99% in 2011, reflecting the changes to the net interest spread.

Provision for Loan and Lease Losses

The Company's provision for loan and lease losses decreased $1.4 million from $3.9 million in 2010 to $2.5 million in 2011. The decrease was a result of a provision recovery of $0.5 million for the leasing portfolio in 2011, compared with a provision for lease losses of $1.5 million in 2010. This $2.0 million improvement in leasing provision was somewhat offset by the increase in the provision for loan losses from $2.4 million in 2010 to $3.0 million in 2011. The provision for loan losses in 2011 stemmed mostly from growth in the loan portfolio, the increase in reserves on several impaired loan relationships, and an increase in historical loss and qualitative factors to account for increased risk in the portfolio. Five impaired relationships with significant related allowance that were either commercial real estate or commercial and industrial loans accounted for $0.9 million in provision for loan losses in 2011. The provision for impaired loans was a mix of added reserves for impaired loans that were already impaired as of December 31, 2010 and newly impaired loans in 2011 that had a measureable impairment requiring additional specific reserve. The net charge-off ratio increased from 0.10% in 2010 to 0.26% in 2011, resulting in an increase in the Company's historical loss factors. With the Company's loan portfolio continuing to grow at a fast pace compared to peers, there is increased risk in underwriting and ongoing portfolio management that was reflected in an increase in the Company's qualitative loss factors.

The ratio of non-performing loans and leases to total loans and leases was slightly lower at 2.60% at December 31, 2011 compared with 2.64% at December 31, 2010 and December 31, 2009. Trends in non-performing loans and charge-offs are good indicators of credit quality and provide context for the movement in the provision for loan and lease losses.

Non-Interest Income

Total non-interest income decreased $0.2 million, or 1.6%, from 2010 to 2011. There were two primary factors driving the decrease. The first factor is the decrease in insurance service and fee revenue of $0.1 million, or 1.3%, to $6.9 million. TEA's revenue is the largest component of non-interest income at 55.5% of total non-interest income. TEA remains a source of diversification in the earnings of the Company and helps generate income not directly impacted by difficult credit or interest rate environments. However, during 2011, TEA revenue growth continued to remain stagnant due to the soft insurance market. Second, deposit service charges declined $0.1 million, or 6.0%, from prior year, to $1.8 million. This is attributable to decreases in overdraft fees as a result of the full year effect of new regulations that became effective in July 2010. Despite the decrease, deposit service charges remained the second largest component of non-interest income at 14.3% of total non-interest income.

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Non-Interest Expense

Total non-interest expense increased $1.1 million, or 4.3%, from $26.1 million in 2010 to $27.2 million in 2011. The largest increase in non-interest expense was in salaries and employee benefits, which increased $1.0 million, or 6.7%, in comparison to 2010. Most of the rest of the increase stems from merit increases, added positions, and expense related to an increase in the Company's 401(k) matching contributions. In 2011, the Company continued to add commercial loan officers along with the corresponding support staff such as credit analysts and a special assets manager.

Advertising expense increased $0.2 million, or 29.5%, as the Company attempted to lure customers displaced from bank merger and acquisition activity in Western New York. In 2011, HSBC Bank USA, the market leader in the Company's footprint of Western New York, announced that it was selling all of its retail branches to First Niagara Financial Group ("First Niagara"). First Niagara subsequently announced that it would be selling some of the acquired branches to comply with anti-trust regulations.

Professional service expenses increased $0.2 million, or 15.9%, to $1.8 million in 2011. Most of the increase is attributable to increased legal expenses from non-performing loans. While non-performing loans as a percentage of total loans and leases have actually decreased over the past two years, the non-accruing loan portfolio has increased 57% to $13.9 million over the past two years. As a result, the Company has had to dedicate more resources to properly manage the larger workout portfolio.

These increases were somewhat offset by decreases in FDIC insurance premiums and intangible amortization expense. After a significant increase in FDIC insurance premiums in 2009 and 2010, the Company benefited from the change in calculation of the assessment base stipulated by the Dodd-Frank Act. The change in the calculation resulted in a decrease in FDIC insurance expense of $0.4 million to $0.7 million.

In 2011, the Company benefited from the expiration of the amortization of intangibles related to its purchase of Suchak Data Systems in 2008. Amortization expense declined from $0.9 million in 2010 to $0.5 million in 2011.

The Company's efficiency ratio was 69.7% in 2011, an increase from 2010's ratio of 67.9% as a result of the Company's declining net interest margin, declining fee income, and investments in additional employees and infrastructure.

FINANCIAL CONDITION

The Company had total assets of $809.7 million at December 31, 2012, an increase of $68.8 million or 9.3% from $740.9 million at December 31, 2011. Net loans of $573.2 million increased 0.2% or $1.3 million over 2011. Securities and interest-bearing deposits at banks increased $66.9 million or 62.5% over 2011. Deposits increased by $62.8 million or 10.2%. Stockholders' equity increased $5.8 million or 8.5% from 2011.

Securities Activities

The primary objectives of the Bank's securities portfolio are to provide liquidity and maximize income while preserving safety of principal. Secondary objectives include: providing collateral to secure local municipal deposits, the investment of funds during periods of decreased loan demand, interest rate sensitivity considerations, supporting local communities through the purchase of tax-exempt securities and tax planning considerations. The Bank's Board of Directors is responsible for establishing overall policy and reviewing performance of the Bank's investments.

Under the Bank's policy, acceptable portfolio investments include: United States ("U.S.") Government obligations, obligations of federal agencies or U.S. Government-sponsored enterprises, mortgage backed securities, municipal obligations (general obligations, revenue obligations, school districts and non-rated issues from the Bank's general market area), banker's acceptances, certificates of deposit, Industrial Development Authority Bonds, Public Housing Authority Bonds, corporate bonds (each corporation limited to the Bank's legal lending limit), collateralized mortgage obligations, Small Business Investment Companies (SBIC), Federal Reserve stock and Federal Home Loan Bank stock.

In regard to municipal securities, the Company's general investment policy is that in-state securities must be rated at least Moody's Baa (or equivalent) at the time of purchase. The Company reviews the ratings report and municipality financial statements and prepares a pre-purchase analysis report before the purchase of any municipal securities. Out-of-state issues must be rated by Moody's at least Aa (or equivalent) at the time of purchase. The Company did not own any out-of-state municipal bonds at December 31, 2012 or December 31, 2011. Bonds rated below A are reviewed periodically to ensure their continued credit worthiness. While purchase of non-rated municipal securities is permitted, such purchases are limited to bonds issued by municipalities in the Company's general market area. Those municipalities are typically customers of the Bank whose financial situation is familiar to management. The financial

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statements of the issuers of non-rated securities are reviewed by the Bank and a credit file of the issuers is kept on each non-rated municipal security with relevant financial information.

Although concerns have been raised in the marketplace recently about the health of municipal bonds, the Company has not experienced any credit troubles in this portfolio and does not believe any credit troubles are imminent. Aside from the non-rated municipal securities to local municipalities discussed above that are considered held-to-maturity, all of the Company's available-for-sale municipal bonds are investment-grade government obligation ("G.O.") bonds. G.O. bonds are generally considered safer than revenue bonds because they are backed by the full faith and credit of the government while revenue bonds rely on the revenue produced by a particular project. All of the Company's municipal bonds are to municipalities in New York State. To the Company's knowledge, there has never been a default of a NY G.O. in the history of the state. The Company believes that its risk of loss on default of a G.O. municipal bond for the Company is relatively low. However, historical performance does not guarantee future performance

Pursuant to FASB Accounting Standards Codification ("ASC") 320, "Investments – Debt and Equity Securities," which establishes accounting treatment for investments in securities, all securities in the Bank's investment portfolio are either designated as "held to maturity" or "available for sale."

Fair values for available for sale securities are determined using independent pricing services and market-participating brokers. The Company's independent pricing service is Interactive Data. Interactive Data utilizes evaluated pricing models that vary by asset class and incorporate available trade, bid and other market information for structured securities, cash flow and, when available, loan performance data. Because many fixed income securities do not trade on a daily basis, Interactive Data's evaluated pricing applications apply information as applicable through processes, such as benchmarking of like securities, sector groupings, and matrix pricing, to prepare evaluations. In addition, Interactive Data uses model processes, such as the Option Adjusted Spread model, to assess interest rate impact and develop prepayment scenarios. The models and the process take into account market convention. For each asset class, a team of evaluators gathers information from market sources and integrates relevant credit information, perceived market movements and sector news into the evaluated pricing applications and models. Interactive Data, at times, may determine that it does not have sufficient verifiable information to value a particular security. In these cases the Company will utilize valuations from another pricing service.

Management believes that it has a sufficient understanding of the third party service's valuation models, assumptions and inputs used in determining the fair value of securities to enable management to maintain an appropriate system of internal control. On a quarterly basis the Company reviews changes, as submitted by Interactive Data, in the market value of its securities portfolio. Individual changes in valuations are reviewed for consistency with general interest rate movements and any known credit concerns for specific securities. Additionally, on an annual basis the Company has its entire securities portfolio priced by a second pricing service to determine consistency with another market evaluator. If, on the Company's review or in comparing with another servicer, a material difference between pricing evaluations were to exist, the Company may submit an inquiry to Interactive Data regarding the data used to value a particular security. If the Company determines it has market information that would support a different valuation than Interactive Data's evaluation it can submit a challenge for a change to that security's valuation. There were no material differences in valuations noted in 2012 or 2011.

Securities and interest-bearing deposits at banks made up 20.0% of the Company's total average interest-earning assets in 2012 compared with 17.8% in 2011. These assets provide the Company with additional sources of liquidity and income and act as collateral for the Bank's municipal deposits. The Company's securities portfolio outstanding balances decreased 7.7% from $103.8 million at December 31, 2011 to $95.8 million at December 31, 2012, while the interest-bearing deposits at banks grew from $3.2 million to $78.1 million over the same time period. The interest-bearing deposits are liquid interest-bearing cash accounts at correspondent banks. The significant increase in the Company's cash position is a result of the rapid rate of deposit growth combined with the lack of loan growth in 2012. While total deposits grew $62.8 million in 2012, total gross loans actually decreased $0.5 million. In a difficult economy like the current environment, creditworthy businesses are less likely to take risks, make large investments, and seek credit, and are more likely to deposit their excess cash flow in a safe investment like a bank deposit. With long-term rates at historic lows and decreasing even further in 2012, the Company did not make significant investments from the excess liquidity in non-core assets such as long-term bonds. In 2013, the Company intends to execute a strategy of disciplined deposit pricing which management expects to slow deposit growth and buffet the Company's net interest margin. There is also $10.0 million and $9.0 million in FHLB borrowings which will mature in 2013 and 2014, respectively. If the current liquidity position holds, these borrowings would likely not be replaced. Alternatively, the Company plans to seek to aggressively grow its core loan portfolio after an unusually high number of large pay-offs in the fourth quarter of 2012 resulted in an overall flat year for loan growth in 2012. Over time, management anticipates that its excess liquidity will shrink as the balance sheet mix shifts based on the preceding strategy. The Company's largest concentration at December 31, 2012 was in tax-advantaged municipal bonds, which comprised 36.8% of the total at December 31, 2012

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versus 33.8% at December 31, 2011. Government-sponsored mortgage-backed securities made up 33.7% of the portfolio at December 31, 2012 versus 34.9% at December 31, 2011 and U.S. government-sponsored agency bonds of various types made up 29.6% of the portfolio at December 31, 2012 versus 28.3% at December 31, 2011.

As a member of both the Federal Reserve System and the FHLB, the Bank is required to hold stock in those entities. The Bank held $1.8 million in FHLB stock as of December 31, 2012 and 2011, respectively, and $1.4 million in FRB stock at December 31, 2012 and 2011, respectively.

All fixed and adjustable rate mortgage pools contain a certain amount of risk related to the uncertainty of prepayments of the underlying mortgages. Interest rate changes have a direct impact on prepayment rates. The Company uses a third-party developed model to monitor the average life and yield volatility of mortgage pools under various interest rate assumptions.

The Company designates all securities at the time of purchase as either "held to maturity" or "available for sale." Securities designated as held to maturity are stated on the Company's Consolidated Balance Sheets included under Item 8 of this Annual Report on Form 10-K at amortized cost. Those designated as available for sale are reported at fair market value. At December 31, 2012, $3.7 million in securities were designated as held to maturity. These bonds are primarily municipal investments that the Bank has made in its local market area.

The available for sale portfolio totaled $92.1 million or approximately 96.1% of the Company's securities portfolio at December 31, 2012. Net unrealized gains and losses on available for sale securities resulted in a net unrealized gain of $2.5 million at December 31, 2012, as compared with a net unrealized gain of $2.5 million at December 31, 2011. Unrealized gains and losses on available-for-sale securities are reported, net of taxes, as a separate component of stockholders' equity. For the year ended December 31, 2012, the impact on stockholders' equity was a net unrealized loss, net of taxes, of approximately $0.1 million.

Certain securities available for sale were in an unrealized loss position at December 31, 2012. Management has assessed those securities available for sale in an unrealized loss position at December 31, 2012 and determined the decline in fair value below amortized cost to be temporary. In making this determination, management considered the period of time the securities were in a loss position, the percentage decline in comparison to the securities amortized cost, the financial condition of the issuer (primarily government or government-sponsored enterprises) and the Company's ability and intent to hold these securities until their fair value recovers to their amortized cost. Management believes the decline in fair value is primarily related to market interest rate fluctuations and not to the credit deterioration of the individual issuer.

Income from securities held in the Bank's investment portfolio represented approximately 9.2% of total interest income of the Company in 2012 as compared with 10.9% in 2011 and 10.5% in 2010. At December 31, 2012, the

Bank’s securities portfolio of $95.8 million consisted primarily of state and municipal securities, mortgage-backed securities issued by the Federal National Mortgage Association (“FNMA”) and Federal Home Loan Mortgage Corp ("FHLMC"), and U.S. and federal agency obligations. The increase in investment interest income from 2010 to 2011 was due to the increase in average balances and was partially offset by a slight decline in investment yields. The $0.5 million decrease in investment securities income in 2012 was a result of a significant decline in investment yields as sustained stimulus by the FRB continued to drive down bond yields to all-time lows. Taxable investment yields dropped from 3.40% in 2011 to 2.76% in 2012 and tax-exempt security yields fell from 3.85% in 2011 to 3.38% in 2012.

Available for sale securities with a total fair value of $68.0 million at December 31, 2012 were pledged as collateral to secure public deposits and for other purposes required or permitted by law.

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The following table summarizes the Bank's securities with those designated as available for sale valued at fair value and securities designated as held to maturity at amortized cost as of December 31, 2012, 2011 and 2010:

	2012	2011	2010
	(in thousands)		
Available for Sale:			
Debt Securities			
U.S. government agencies	$ 28,332	$ 30,252	$ 23,644
States and political subdivisions	31,469	32,326	36,297
Total debt securities	$ 59,801	$ 62,578	$ 59,941
Mortgage-backed securities			
FNMA	$ 16,077	$ 20,718	$ 10,462
FHLMC	6,481	8,321	9,567
GNMA	8,013	6,143	4,801
CMO's	1,691	2,221	2,651
Total mortgage-backed securities	$ 32,262	$ 37,403	$ 27,481
Total available for sale	$ 92,063	$ 99,981	$ 87,422
Held to Maturity:			
Debt Securities			
States and political subdivisions	$ 3,744	$ 3,802	$ 2,140
Total securities designated as held to maturity	$ 3,744	$ 3,802	$ 2,140

The following table sets forth the contractual maturities and weighted average interest yields of the Bank's securities portfolio (yields on tax-exempt obligations are not presented on a tax-equivalent basis) as of December 31, 2012. Expected maturities will differ from contracted maturities since issuers may have the right to call or prepay obligations without penalties.

Maturing

	Within One Year		After One But Within Five Years		After Five But Within Ten Years		After Ten Years	
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield
	(dollars in thousands)							
Available for Sale:								
Debt Securities								
U.S. Government agencies	$ -	-	$ 7,624	3.52%	$ 16,349	2.43%	$ 4,359	5.38%
States and political subdivisions	2,797	4.25%	9,937	3.79%	13,995	3.67%	4,740	4.33%
Total debt securities	$ 2,797	4.25%	$ 17,561	3.68%	$ 30,344	3.00%	$ 9,099	4.83%
Mortgage-backed securities								
FNMA	$ -	-	$ -	-	$ 4,163	4.55%	$ 11,914	3.60%
FHLMC	-	-	-	-	634	5.22%	5,847	3.14%
GNMA	-	-	-	-	-	-	8,013	3.87%
CMO's	-	-	-	-	12	4.25%	1,679	2.95%
Total mortgage-backed securities	$ -	-	$ -	-	$ 4,809	4.63%	$ 27,453	3.54%
Total available for sale	$ 2,797	4.25%	$ 17,561	3.68%	$ 35,153	3.22%	$ 36,552	3.86%
Held to Maturity:								
U.S. Government agencies	$ -	-	$ -	-	$ -	-	$ -	-
States and political subdivisions	2,241	1.26%	317	2.94%	516	2.06%	670	3.54%
Total held to maturity	$ 2,241	1.26%	$ 317	2.94%	$ 516	2.06%	$ 670	3.54%
Total securities	$ 5,038	2.92%	$ 17,878	3.66%	$ 35,669	3.21%	$ 37,222	3.86%

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LENDING AND LEASING ACTIVITIES

The Bank has a loan and lease policy which is approved by its Board of Directors on an annual basis. The loan and lease policy governs the conditions under which loans and leases may be made, addresses the lending authority of Bank officers, documentation, appraisal policy, charge-off policies and desired portfolio mix. The Bank's lending limit to any one borrower is subject to regulation by the OCC. The Bank continually monitors its loan portfolio to review compliance with new and existing regulations.

The Bank offers a variety of loan products to its customers, including residential and commercial real estate mortgage loans, commercial loans, and installment loans. The Bank primarily extends loans to customers located within the Western New York area. Until it announced that it was exiting the direct financing leasing business in April 2009, ENL originated direct financing leases in all 48 contiguous states. Interest income on loans and leases represented approximately 90.8% of the total interest income of the Company in 2012 and approximately 89.1% and 89.5% of total interest income in 2011 and 2010, respectively. The Bank's loan and lease portfolio, net of the allowances for loan and lease losses, totaled $573.2 million and $571.9 million at December 31, 2012 and December 31, 2011, respectively. The net loan and lease portfolio represented approximately 70.8% and 77.2% of the Company's total assets at December 31, 2012 and December 31, 2011, respectively.

The following table summarizes the major classifications of the Bank's loans and leases as of the dates indicated:

	December 31,				
	2012	2011	2010	2009	2008
	(in thousands)				
Mortgage loans on real estate:					
Residential mortgages	$ 68,135	$ 73,579	$ 69,958	$ 67,330	$ 55,450
Commercial and multi-family	323,777	306,683	261,371	243,415	181,369
Construction-residential	811	2,392	1,320	2,086	1,280
Construction-commercial	28,941	27,887	32,332	18,156	14,017
Home equities	56,366	54,673	53,120	50,049	39,348
Total real estate loans	478,030	465,214	418,101	381,036	291,464
Direct financing leases	1,612	6,021	15,475	31,486	58,639
Commercial and industrial loans	99,951	109,513	91,445	73,145	54,838

Consumer loans	1,294	1,677	2,458	2,883	1,609
Other	1,342	586	252	493	365
Net deferred loan and lease origination costs	666	394	247	525	798
	582,895	583,405	527,978	489,568	407,713
Allowance for loan and lease losses	(9,732)	(11,495)	(10,424)	(6,971)	(6,087)
Loans and leases, net	$ 573,163	$ 571,910	$ 517,554	$ 482,597	$ 401,626

Real Estate Loans

Approximately 82.0% of the Bank's total loan and lease portfolio at December 31, 2012 consisted of real estate loans or loans collateralized by mortgages on real estate, including residential mortgages, commercial mortgages and other types of real estate loans. The Bank's real estate loan portfolio was $478.0 million at December 31, 2012, compared with $465.2 million at December 31, 2011. The real estate loan portfolio increased by approximately 2.8% in 2012 over 2011 compared with an increase of 11.3% in 2011 over 2010.

The Bank offers fixed rate residential mortgage loans with terms of 10 to 30 years with, typically, up to an 80% loan-to-value ("LTV") ratio. Any loans with a greater than 80% LTV have private mortgage insurance. Fixed rate residential mortgage loans outstanding totaled $54.7 million at December 31, 2012, which was approximately 9.7% of total loans and leases outstanding, compared with $57.5 million and 9.9%, respectively, at December 31, 2011. This balance did not include any construction residential mortgage loans, which are discussed below. The Bank has a contractual arrangement with FNMA, pursuant to which the Bank sells certain mortgage loans to FNMA and the Bank retains the

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servicing rights to those loans. The Bank determines with each origination of residential real estate loans which desired maturities, within the context of overall maturities in the loan portfolio, provide the appropriate mix to optimize the Bank's ability to absorb the corresponding interest rate risk within the Company's tolerance ranges.

In 2012, the Bank sold $24.6 million in mortgages to FNMA under this arrangement, compared with $24.1 million in mortgages sold in 2011. Historically low interest rates resulted in the Bank selling 65.6% of new loans in an effort to mitigate the interest rate risk of holding long-term fixed rate loans in portfolio. Originations decreased from $43.0 million in 2011 to $37.5 million in 2012. The primary reasons for the decrease in originations were the Company's more disciplined pricing and the departure of multiple loan officers, as the Company focused on compliance and profitability over production. Much of the activity at the Bank and in the market in general was refinancing activity, in which customers replace their mortgage loans with a loan with a lower interest rate. The refinancing activity, combined with lower production and normal roll-off, led to a decrease in balances of total residential mortgages of $5.4 million, or 7.4%.

The Bank currently retains the servicing rights on $73.7 million in mortgages sold to FNMA at December 31, 2012, compared with $62.4 million at December 31, 2011. The Company has recorded a net servicing asset for such loans of $0.5 million at December 31, 2012, compared with $0.4 million at December 31, 2011. The value of the mortgage servicing rights increased due to the increase in the size of the servicing portfolio. However, lower market interest rates at December 31, 2012 compared with December 31, 2011 resulted in the Company's valuation model projecting higher prepayment speeds and a lower duration for the existing loans in the servicing portfolio, somewhat offsetting the increased value attributable to the additional loans sold to FNMA.

The Bank offers adjustable rate residential mortgage loans with terms of up to 30 years. Rates on these mortgage loans remain fixed for a predetermined time and are adjusted annually thereafter. At December 31, 2012, the Bank's outstanding adjustable rate residential mortgage loans were $11.4 million or 2.0% of total loans and leases outstanding as compared with $16.1 million or 2.8% of total loans and leases at December 31, 2011. With rates on fixed rate mortgage products at all-time lows, there has been little demand for variable-rate products which has resulted in a decline in variable rate mortgage loan balances.

Overall, residential real estate loans decreased $5.4 million, or 7.4%, from $73.6 million at December 31, 2011 to $68.1 million at December 31, 2012.

The Bank also offers commercial mortgage loans with up to an 80% LTV ratio for up to 20 years on a variable and fixed rate basis. To the extent required, loans exceeding an 80% LTV are reported on an exception report to the Board of Directors. Many of these mortgage loans either mature or are subject to a rate call after three to five years. The Bank's outstanding commercial mortgage loans were $323.8 million at December 31, 2012, which was 55.6% of total loans and leases outstanding, compared with $306.7 million and 52.6%, respectively, at December 31, 2011. The growth is attributable to the Bank's loan officers continuing to capitalize on opportunities available in the market. The Bank believes that the strong relationships with customers in the local community that have been fostered over the years with its loan officers have resulted in robust loan production in 2012. The balance at December 31, 2012 included $92.3 million in fixed rate and $231.5 million in variable rate commercial mortgage loans, which include interest rate calls.

The Bank also offers other types of loans collateralized by real estate, such as home equity loans. The Bank offers home equity loans at variable and fixed interest rates with terms of up to 15 years and up to an 85% combined LTV ratio. To the extent required, loans exceeding an 85% LTV ratio are reported on an exception report to the Board of Directors. At December 31, 2012, the real estate loan portfolio included $56.4 million of home equity loans outstanding, which represented 9.7% of total loans and leases outstanding, compared with $54.7 million and 9.4% at December 31, 2011, respectively. The growth is attributable to strong consumer demand for historically low-rate variable-rate home equity loans. The total home equity portfolio included $48.2 million in variable rate loans and $8.2 million in fixed rate loans.

The Bank also offers both residential and commercial real estate construction loans at up to an 80% LTV ratio at fixed interest or adjustable interest rates and multiple maturities. At December 31, 2012, fixed rate real estate construction loans outstanding totaled $2.2 million, or 0.4% of total loans and leases outstanding, and adjustable rate construction loans outstanding totaled $27.6 million, or 4.7% of total loans and leases outstanding. At December 31, 2011, fixed rate real estate construction loans outstanding totaled $4.0 million or 0.7% of total loans and leases outstanding, and adjustable rate construction loans outstanding totaled $26.3 million or 4.5% of total loans and leases outstanding.

Direct Financing Leases

Direct financing leases totaled $1.6 million and $6.0 million at December 31, 2012 and 2011, respectively, representing 0.3% and 1.0% of the Bank's total loans and leases outstanding at December 31, 2012 and 2011, respectively. The

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decline reflects management's decision to exit the leasing business and to manage the remaining portfolio through its estimated maturity in 2014.

Commercial and Industrial Loans

The Bank offers commercial and industrial ("C&I") loans on a secured and unsecured basis, including lines of credit and term loans at fixed and variable interest rates and multiple maturities. The Bank's C&I loan portfolio totaled $100.0 million at December 31, 2012, compared with $109.5 million and $91.4 million at December 31, 2011 and 2010, respectively. The portfolio is 8.7% smaller at December 31, 2012 than the previous year-end, but 9.3% larger than two years prior. The growth over two years is attributable to an increased number of C&I loan officers and good results achieved through the Bank's community-focused and relationship-based lending approach in the local market. However, in 2012, there were several large loans that unexpectedly paid off in the fourth quarter. This impact more than offset robust production of smaller-balance loans throughout the year. In addition, commercial line usage declined year over year. Commercial loans represented 17.2% and 18.8% of the Bank's total loans at December 31, 2012 and 2011, respectively.

Collateral for C&I loans, where applicable, may consist of inventory, receivables, equipment and other business assets. At December 31, 2012, 60.1% of the Bank's C&I loans were at variable rates which are typically tied to the prime rate. The Company has a small number of loans that are tied to LIBOR.

Consumer Loans

The Bank's consumer installment loan portfolio totaled $1.3 million and $1.7 million at December 31, 2012 and 2011, respectively, representing 0.2% and 0.3% of the Bank's total loans and leases outstanding at December 31, 2012 and 2011, respectively. Traditional installment loans are offered at fixed interest rates with various maturities of up to 60 months, on a secured and unsecured basis. This segment of the portfolio is done on an accommodation basis for customers. The Company does not actively try to grow the portfolio in a significant way.

Other Loans

Other loans totaled $1.3 million and $0.6 million at December 31, 2012 and December 31, 2011, respectively. Other loans consisted primarily of overdrafts and loan clearing accounts.

Loan Maturities and Sensitivities of Loans to Changes in Interest Rates

The following table shows the maturities of commercial loans and real estate construction loans outstanding as of December 31, 2012 and the classification of such loans due after one year according to sensitivity to changes in interest rates.

	Within One Year	After One But Within Five Years	After Five Years	Total
	(in thousands)			
Commercial	$ 10,685	$ 58,374	$ 30,892	$ 99,951
Real estate construction	23,997	5,629	126	29,752
	$ 34,682	$ 64,003	$ 31,018	$ 129,703
Loans maturing after one year with:				
Fixed Rates		$ 18,405	$ 20,432	
Variable Rates		45,598	10,586	
		$ 64,003	$ 31,018	

SOURCES OF FUNDS

General

Customer deposits represent the primary source of the Bank’s funds for lending and other investment purposes. In addition to deposits, other sources of funds include loan and lease repayments, loan sales on the secondary market,

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interest and dividend income from investments, matured investments, and borrowings from the Federal Home Loan Bank (“FHLB”) and from correspondent banks First Tennessee Bank and M&T Bank.

Deposits

The Bank offers a variety of deposit products, including checking, savings, NOW accounts, certificates of deposit and jumbo certificates of deposit. Bank deposits are insured up to the limits provided by the FDIC. The following table details the Bank’s deposits as of the dates indicated:

	December 31,		
	2012	2011	2010
	(in thousands)		
Demand deposits	$ 123,405	$ 118,037	$ 98,016
NOW accounts	65,753	50,761	32,683
Regular savings	357,741	313,777	249,410
Muni-vest savings	23,183	20,161	22,000
Time deposits, $100,000 and over	42,083	39,557	57,302
Other time deposits	66,827	73,910	85,046
Total	$ 678,992	$ 616,203	$ 544,457

The following schedule sets forth the maturities of the Bank’s time deposits as of December 31, 2012:

	Time Deposit Maturity Schedule (in thousands)				
	0-3 Mos.	3-6 Mos.	6-12 Mos.	Over 12 Mos.	Total
Time deposits - $100,000 and over	$ 1,074	$ 2,018	$ 3,633	$ 35,358	$ 42,083

Other time deposits	6,690	6,801	11,656	41,680	66,827
Total time deposits	$ 7,764	$ 8,819	$ 15,289	$ 77,038	$ 108,910

Total deposits increased $62.8 million or 10.2% in 2012 from 2011. The Company successfully grew core transactional checking accounts, including non-interest bearing demand deposits and interest-bearing NOW accounts, by 12.0% to $189.2 million at December 31, 2012. Non-interest bearing demand deposits increased by $5.2 million, or 4.4%, to $123.4 million as the Company was able to attract new core customers and some current commercial customers kept higher cash balances in a difficult economy. NOW accounts increased by 29.5%, or $15.0 million, to $65.8 million. The Company's Better Checking product rewards customers with premium interest rates on checking balances and ATM fee refunds if the customers meet certain qualifications including direct deposit and frequent use of their debit cards. This product continued to attract new customers in 2012 and drove the increase in NOW balances.

Much of the organic growth in savings deposits in 2012 was due to the Better Savings account offered by the Bank. The Bank paid a competitive interest rate on that product throughout 2012. The Company believes this product was popular because customers preferred to keep their deposits liquid in a low-interest rate environment with a difficult economy. With long-term rates so low, customers often do not believe there is enough value in locking up their funds long-term. In addition, the Company's focus on C&I lending helped drive an increase in commercial savings account balances. The result of the growth in Better Savings and commercial savings balances is reflected in the growth of total regular savings accounts, which increased $47.0 million, or 14.1%, to $380.9 million in 2012.

Time deposits decreased $4.6 million, or 4.0%, from $113.5 million as of December 31, 2011 to $108.9 million at December 31, 2012. Customers moved into more liquid products such as the Better Savings account referred to above. Also, given the excess liquidity provided by the growth in checking and savings accounts, management did not replace brokered time deposits as they matured in 2012. Because the interest rate environment continues to remain low, the average rate paid on time deposits fell from 2.23% in 2011 to 1.75% in 2012.

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The following table shows daily average deposits and average rates paid on significant deposit categories by the Bank (dollars in thousands):

	2012		2011		2010	
	Average Balance	Weighted Average Rate	Average Balance	Weighted Average Rate	Average Balance	Weighted Average Rate
Demand deposits	$ 119,805	0.00%	$ 108,522	0.00%	$ 92,072	0.00%
NOW accounts	59,811	1.03%	44,639	1.23%	24,981	1.00%
Regular Savings	341,739	0.57%	280,606	0.72%	237,939	0.69%
Muni-vest savings	24,937	0.32%	27,272	0.48%	30,005	0.48%
Time deposits	109,508	1.75%	131,171	2.23%	142,360	2.54%
Total	$ 655,800	0.69%	$ 592,210	0.95%	$ 527,357	1.07%

Federal Funds Purchased and Other Borrowed Funds. Another source of the Bank's funds for lending and investing activities at December 31, 2012 consisted of short and long term borrowings from the Federal Home Loan Bank.

Other borrowed funds consisted primarily of various advances from the FHLB with both fixed and variable interest rate terms ranging from 3.01% to 3.55%. The maturities and weighted average rates of other borrowed funds at December 31, 2012 are as follows (dollars in thousands):

	Maturities	Weighted Average Rate
2013	$ 10,000	3.28%
2014	9,000	3.53%
2015	-	-
2016	-	-
Thereafter	-	-
Total	19,000	3.39%

Securities Sold Under Agreements to Repurchase

The Bank enters into agreements with certain customers to sell securities owned by the Bank to those customers and repurchase the identical security, generally within one day. No physical movement of the securities is involved. The customer is informed that the securities are held in safekeeping by the Bank on behalf of the customer. Securities sold under agreements to repurchase totaled $12.1 million at December 31, 2012 compared to $9.0 million at December 31, 2011. Balances can vary day to day based on customer needs.

Pension

The Bank maintains a qualified defined benefit pension plan (the "Pension Plan"), which covered substantially all employees of the Company at the time the Pension Plan was frozen on January 31, 2008. All benefits eligible participants accrued in the Pension Plan to the freeze date have been retained. Employees have not accrued additional benefits in the Pension Plan from that date. Employees will be eligible to receive these benefits at normal retirement age. Additionally, the Company has entered into individual retirement agreements with certain of its executive officers providing for unfunded supplemental pension benefits under the Company's Supplemental Executive Retirement Plan and Senior Executive Supplemental Executive Retirement Plan (collectively, the "SERP plans"). The Company's pension expense for the Pension Plan and the SERP plans approximated $0.6 million, $0.5 million and $0.5 million for each of the years ended December 31, 2012, 2011 and 2010, respectively, and is calculated based upon a number of actuarial assumptions, including an expected long-term rate of return on the Company's plan assets of 7.50% for 2012, 2011 and 2010 for the Pension Plan; no compensation rate increases for 2012, 2011, and 2010 for the Pension Plan and compensation rate increases of 3.50%, 3.12%, and 4.36% in 2012, 2011 and 2010, respectively, for the SERP plans.

The expected long-term rate of return on pension plan assets assumption was determined based on historical returns earned by equity and fixed income securities, adjusted to reflect future return expectations based on pension plan

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targeted asset allocation. The SERP Plans are unfunded so there is no return on plan assets assumption. In evaluating compensation rate increases, the Company evaluated historical salary data, as well as expected future increases. The compensation rate increase assumption is zero for the Pension Plan because the Pension Plan has been frozen and employees can no longer accrue additional benefits. The Company will continue to evaluate its actuarial assumptions, including its expected rate of return and compensation rate increases at least annually, and will adjust as necessary.

The Company bases its determination of pension expense or income on a market-related valuation of assets, which reduces year-to-year volatility. Investment gains or losses for this purpose are the difference between the expected return calculated using the market-related value of assets and the actual return based on the market-related value of assets.

The discount rate utilized by the Company for determining future pension obligations is based on a review of long-term bonds that receive one of the two highest ratings given by a recognized rating agency. The discount rate determined on this basis has decreased from 4.46% at December 31, 2011 to 3.88% at December 31, 2012 for the Company's Pension Plan and from 4.34% to 3.17% for the SERP plans.

Management tested the sensitivity of the pension expense to changes in two key assumptions: return on plan assets and the discount rate. A 0.25% decrease in the rate of return on plan assets would have resulted in an increase in pension expense of 15.5% or $7 thousand. A 0.25% decrease in the discount rate would have resulted in an increase in pension expense of 7.2% or $4 thousand. The SERP has no plan assets; therefore there is no rate of return on plan assets. A 0.25% decrease in the discount rate would have resulted in an increase in SERP expense of 1.5% or $8 thousand. Increases of 25 basis points in those assumptions would have resulted in similar changes in amount, but in the opposite direction from the changes presented in the preceding sentences. Since the SERP plans are not funded and the Pension Plan has been frozen, the pension expense is not sensitive to compensation scale increases or decreases.

As of December 31, 2012, the Company had cumulative actuarial losses of approximately $3.5 million that will result in an increase in the Company's future pension expense because such losses at each measurement date exceed 10% of the greater of the projected benefit obligation or the market-related value of plan assets. In accordance with GAAP, net unrecognized gains or losses that exceed that threshold are required to be amortized over the expected service period of active employees, and are included as a component of net pension cost. Amortization of these net actuarial losses had the effect of increasing the Company's pension expense by approximately $171 thousand in 2012, $36 thousand in 2011 and $38 thousand in 2010.

The Company contributed $370,000 to the Pension Plan in 2012.

Liquidity

The Company utilizes cash flows from its investment portfolio and federal funds sold balances to manage the liquidity requirements it experiences due to loan demand and deposit fluctuations. The Bank also has many borrowing options. As a member of the FHLB, the Bank is able to borrow funds at competitive rates. Given the current collateral available, advances of up to $127.7 million can be drawn on the FHLB via the Bank's Overnight Line of Credit Agreement. An amount equal to 25% of the Bank's total assets could be borrowed through the advance programs under certain qualifying circumstances. The Bank also has the ability to purchase up to $14.0 million in federal funds from its correspondent banks. By placing sufficient collateral in safekeeping at the Federal Reserve Bank, the Bank could also borrow at the FRB's discount window. The Company's liquidity needs also can be met by more aggressively pursuing time deposits, or accessing the brokered time deposit market, including the Certificate of Deposit Account Registry Service ("CDARS") network. Additionally, the Company has access to capital markets as a funding source.

The cash flows from the Company's investment portfolio are laddered, so that securities mature at regular intervals, to provide funds from principal and interest payments at various times as liquidity needs may arise. Contractual maturities are also laddered, with consideration as to the volatility of market prices, so that securities are available for sale from time-to-time without the need to incur significant losses. At December 31, 2012, approximately 5.3% of the Company's debt securities had maturity dates of one year or less, and approximately 23.9% had maturity dates of five years or less. In addition, the Company receives regular cash flows on its mortgage-backed securities.

Management, on an ongoing basis, closely monitors the Company's liquidity position for compliance with internal policies, and believes that available sources of liquidity are adequate to meet funding needs in the normal course of business. As part of that monitoring process, management calculates the 90-day liquidity each month by analyzing the cash needs of the Bank. Included in the calculation are liquid assets and potential liabilities. Management stresses the potential liabilities calculation to ensure a strong liquidity position. Included in the calculation are assumptions of some significant deposit run-off as well as funds needed for loan closing and investment purchases. At December 31, 2012, in

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the stress test, the Bank had net short-term liquidity available of $75.5 million as compared with $82.6 million at December 31, 2011. Available assets of $179.6 million divided by public and purchased funds of $116.0 million, resulted in a long-term liquidity ratio of 155% at December 31, 2012, compared with 99% at December 31, 2011.

Management does not anticipate engaging in any activities, either currently or over the long-term, for which adequate funding would not be available and which would therefore result in significant pressure on liquidity. However, continued economic recession could negatively impact the Company's liquidity. The Bank relies heavily on FHLBNY as a source of funds, particularly with its overnight line of credit. To conserve capital, some FHLB branches have suspended dividends, cut dividend payments, and not bought back excess FHLB stock that members hold. FHLBNY has stated that they expect to be able to continue to pay dividends, redeem excess capital stock, and provide competitively priced advances in the future. The most severe problems in FHLB have been at some of the other FHLB branches. Nonetheless, the 12 FHLB branches are jointly liable for the consolidated obligations of the FHLB system. To the extent that one FHLB branch cannot meet its obligations to pay its share of the system's debt, other FHLB branches can be called upon to make the payment.

Systemic weakness in the FHLB could result in higher costs of FHLB borrowings and increased demand for alternative sources of liquidity that are more expensive, such as brokered time deposits, the discount window at the Federal Reserve, or lines of credit with correspondent banks First Tennessee Bank and M&T Bank.

Contractual Obligations

The Company is party to contractual financial obligations, including repayment of borrowings, operating lease payments and commitments to extend credit. The table below presents certain future financial obligations.

	Payments due within time period at December 31, 2012 (in thousands)				
	Total	Less Than 1 Year	1-3 Years	3-5 Years	More Than 5 Years
Contractual Obligations:					
Securities sold under agreement to repurchase	$ 12,111	$ 12,111	$ -	$ -	$ -
Operating lease obligations	7,386	645	1,129	958	4,654
Other borrowed funds	19,000	10,000	9,000	-	-
Junior subordinated debentures	11,330	-	-		