

PEOPLES BANCORP OF NORTH CAROLINA INC  
Form 10-Q  
November 10, 2010

UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended: September 30, 2010

OR

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

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

PEOPLES BANCORP OF NORTH CAROLINA, INC.  
(Exact name of registrant as specified in its charter)

North Carolina  
(State or other jurisdiction of incorporation or organization)

000-27205  
(Commission File No.)

56-2132396  
(IRS Employer Identification No.)

518 West C Street, Newton, North Carolina  
(Address of principal executive offices)

28658  
(Zip Code)

(828) 464-5620  
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities 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 check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes No X

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

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Large  
Accelerate Filer

Accelerated  
Filer

Non-Accelerated  
Filer

Smaller Reporting Company

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

Yes No

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date.

5,539,056 shares of common stock, outstanding at October 31, 2010.

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Statements made in this Form 10-Q, other than those concerning historical information, should be considered forward-looking statements pursuant to the safe harbor provisions of the Securities Exchange Act of 1934 and the Private Securities Litigation Act of 1995. These forward-looking statements involve risks and uncertainties and are based on the beliefs and assumptions of management and on the information available to management at the time that this Form 10-Q was prepared. These statements can be identified by the use of words like “expect,” “anticipate,” “estimate,” and “believe,” variations of these words and other similar expressions. Readers should not place undue reliance on forward-looking statements as a number of important factors could cause actual results to differ materially from those in the forward-looking statements. Factors that could cause actual results to differ materially include, but are not limited to, (1) competition in the markets served by Peoples Bank, (2) changes in the interest rate environment, (3) general national, regional or local economic conditions may be less favorable than expected, resulting in, among other things, a deterioration in credit quality and the possible impairment of collectibility of loans, (4) legislative or regulatory changes, including changes in accounting standards, (5) significant changes in the federal and state legal and regulatory environments and tax laws, (6) the impact of changes in monetary and fiscal policies, laws, rules and regulations and (7) other risks and factors identified in the Company’s other filings with the Securities and Exchange Commission, including but not limited to those described in Peoples Bancorp of North Carolina, Inc.’s annual report on Form 10-K for the year ended December 31, 2009.

## PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

## Consolidated Balance Sheets

(Dollars in thousands)

| Assets  | September 30,<br>2010<br>(Unaudited) | December 31,<br>2009 |
|---|--------------------------------------|----------------------|
| Cash and due from banks, including reserve requirements | \$ 72,467                            | 29,633               |
| Interest bearing deposits                               | 2,844                                | 1,707                |
| Cash and cash equivalents                               | 75,311                               | 31,340               |
| Certificates of deposit                                 | 735                                  | 3,345                |
| Investment securities available for sale                | 227,509                              | 195,115              |
| Other investments                                       | 5,953                                | 6,346                |
| Total securities  | 233,462                              | 201,461              |
| Mortgage loans held for sale                            | 2,114                                | 2,840                |
| Loans   | 743,324                              | 778,056              |
| Less allowance for loan losses                          | (17,718 )                            | (15,413 )            |
| Net loans   | 725,606                              | 762,643              |
| Premises and equipment, net                             | 17,594                               | 17,947               |
| Cash surrender value of life insurance                  | 7,475                                | 7,282                |
| Accrued interest receivable and other assets            | 19,294                               | 21,636               |
| Total assets  | \$ 1,081,591                         | 1,048,494            |
| Liabilities and Shareholders' Equity                    |                                      |                      |
| Deposits:   |                                      |                      |
| Non-interest bearing demand                             | \$ 113,539                           | 117,636              |
| NOW, MMDA & savings                                     | 327,938                              | 290,273              |
| Time, \$100,000 or more                                 | 249,249                              | 233,142              |
| Other time  | 151,579                              | 168,292              |
| Total deposits  | 842,305                              | 809,343              |
| Demand notes payable to U.S. Treasury                   | 352                                  | 636                  |
| Securities sold under agreement to repurchase           | 41,510                               | 36,876               |
| FHLB borrowings   | 70,000                               | 77,000               |
| Junior subordinated debentures                          | 20,619                               | 20,619               |
| Accrued interest payable and other liabilities          | 4,446                                | 4,797                |
| Total liabilities                                       | 979,232                              | 949,271              |

## Shareholders' equity:

|   |              |           |
|---|--------------|-----------|
| Series A preferred stock, \$1,000 stated value;<br>authorized<br>5,000,000 shares; issued and outstanding<br>25,054 shares in 2010 and 2009 | 24,582       | 24,476    |
| Common stock, no par value; authorized<br>20,000,000 shares; issued and outstanding<br>5,539,056 shares in 2010 and 2009                    | 48,269       | 48,269    |
| Retained earnings   | 24,470       | 23,573    |
| Accumulated other comprehensive income  | 5,038        | 2,905     |
| Total shareholders' equity  | 102,359      | 99,223    |
| Total liabilities and shareholders' equity  | \$ 1,081,591 | 1,048,494 |

See accompanying notes to consolidated financial statements.

## PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

## Consolidated Statements of Earnings

(Dollars in thousands, except per share amounts)

|  | Three months ended<br>September 30, |                     | Nine months ended<br>September 30, |                     |
|--|-------------------------------------|---------------------|------------------------------------|---------------------|
|  | 2010<br>(Unaudited)                 | 2009<br>(Unaudited) | 2010<br>(Unaudited)                | 2009<br>(Unaudited) |
| <b>Interest income:</b>                                |                                     |                     |                                    |                     |
| Interest and fees on loans                             | \$ 9,983                            | 10,662              | 30,236                             | 32,603              |
| Interest on federal funds sold                         | -                                   | -                   | -                                  | 1                   |
| <b>Interest on investment securities:</b>              |                                     |                     |                                    |                     |
| U.S. Government agencies                               | 1,365                               | 1,385               | 3,966                              | 3,947               |
| States and political subdivisions                      | 586                                 | 325                 | 1,448                              | 866                 |
| Other  | 61                                  | 31                  | 154                                | 90                  |
| Total interest income                                  | 11,995                              | 12,403              | 35,804                             | 37,507              |
| <b>Interest expense:</b>                               |                                     |                     |                                    |                     |
| NOW, MMDA & savings deposits                           | 866                                 | 789                 | 2,643                              | 2,066               |
| Time deposits  | 1,637                               | 2,213               | 5,259                              | 7,669               |
| FHLB borrowings  | 803                                 | 911                 | 2,505                              | 2,666               |
| Junior subordinated debentures                         | 112                                 | 116                 | 310                                | 445                 |
| Other  | 98                                  | 103                 | 306                                | 312                 |
| Total interest expense                                 | 3,516                               | 4,132               | 11,023                             | 13,158              |
| Net interest income                                    | 8,479                               | 8,271               | 24,781                             | 24,349              |
| Provision for loan losses                              | 4,656                               | 3,139               | 10,217                             | 7,156               |
| Net interest income after provision<br>for loan losses | 3,823                               | 5,132               | 14,564                             | 17,193              |
| <b>Non-interest income:</b>                            |                                     |                     |                                    |                     |
| Service charges  | 1,435                               | 1,511               | 4,195                              | 4,094               |
| Other service charges and fees                         | 523                                 | 472                 | 1,684                              | 1,568               |
| Gain (loss) on sale and write-down<br>of securities    | 1,523                               | (79 )               | 1,691                              | 1,072               |
| Mortgage banking income                                | 125                                 | 129                 | 372                                | 633                 |
| Insurance and brokerage<br>commissions                 | 84                                  | 87                  | 275                                | 286                 |
| Miscellaneous  | 167                                 | 383                 | 1,380                              | 1,287               |
| Total non-interest income                              | 3,857                               | 2,503               | 9,597                              | 8,940               |
| <b>Non-interest expense:</b>                           |                                     |                     |                                    |                     |
| Salaries and employee benefits                         | 3,511                               | 3,596               | 10,464                             | 11,231              |
| Occupancy  | 1,334                               | 1,357               | 3,986                              | 3,990               |

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|  |         |         |        |        |
|--|---------|---------|--------|--------|
| Other  | 2,337   | 2,391   | 6,978  | 7,421  |
| Total non-interest expense                           | 7,182   | 7,344   | 21,428 | 22,642 |
| Earnings before income taxes                         | 498     | 291     | 2,733  | 3,491  |
| Income tax (benefit) expense                         | (42 )   | (9 )    | 454    | 1,206  |
| Net earnings   | 540     | 300     | 2,279  | 2,285  |
| Dividends and accretion on preferred stock           | 348     | 348     | 1,045  | 898    |
| Net earnings (loss) available to common shareholders | \$ 192  | (48 )   | 1,234  | 1,387  |
| Basic net earnings (loss) per common share           | \$ 0.03 | (0.01 ) | 0.22   | 0.25   |
| Diluted net earnings (loss) per common share         | \$ 0.03 | (0.01 ) | 0.22   | 0.25   |
| Cash dividends declared per common share             | \$ 0.02 | 0.07    | 0.06   | 0.24   |

See accompanying notes to consolidated financial statements.



## PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

## Consolidated Statements of Comprehensive Income (Loss)

(Dollars in thousands)

|  | Three months ended<br>September 30, |                     | Nine months ended<br>September 30, |                     |
|--|-------------------------------------|---------------------|------------------------------------|---------------------|
|  | 2010<br>(Unaudited)                 | 2009<br>(Unaudited) | 2010<br>(Unaudited)                | 2009<br>(Unaudited) |
| Net earnings   | \$ 540                              | 300                 | 2,279                              | 2,285               |
| Other comprehensive income<br>(loss):  |                                     |                     |                                    |                     |
| Unrealized holding gains on<br>securities<br>available for sale  | 3,251                               | 2,560               | 5,914                              | 839                 |
| Reclassification adjustment for<br>losses (gains)<br>net of write-downs of securities<br>available for<br>sale included in net earnings          | (1,523 )                            | 79                  | (1,691 )                           | (1,072 )            |
| Unrealized holding losses on<br>derivative<br>financial instruments qualifying as<br>cash flow<br>hedges   | (329 )                              | (304 )              | (729 )                             | (2,294 )            |
| Reclassification adjustment for<br>gains on<br>derivative financial instruments<br>qualifying as<br>cash flow hedges included in net<br>earnings | -                                   | (25 )               |                                    | (25 )               |
| Total other comprehensive income<br>(loss),<br>before income taxes   | 1,399                               | 2,310               | 3,494                              | (2,552 )            |
| Income tax expense (benefit)<br>related to other<br>comprehensive income:  |                                     |                     |                                    |                     |
| Unrealized holding gains on<br>securities<br>available for sale  | 1,266                               | 997                 | 2,304                              | 327                 |
| Reclassification adjustment for<br>losses (gains)  |                                     |                     |                                    |                     |

|  |      |       |       |       |       |       |        |     |
|--|------|-------|-------|-------|-------|-------|--------|-----|
| net of write-downs of securities<br>available for<br>sale included in net earnings                       | (593 | )     | 30    | (659  | )     | (418  | )      |     |
| Unrealized holding losses on<br>derivative<br>financial instruments qualifying as<br>cash flow<br>hedges | (128 | )     | (158  | )     | (284  | )     | (683   | )   |
| Total income tax expense (benefit)<br>related to<br>other comprehensive income                           | 545  |       | 869   |       | 1,361 |       | (774   | )   |
| Total other comprehensive income<br>(loss),<br>net of tax  | 854  |       | 1,441 |       | 2,133 |       | (1,778 | )   |
| Total comprehensive income   | \$   | 1,394 |       | 1,741 |       | 4,412 |        | 507 |

See accompanying notes to consolidated financial statements.

## PEOPLES BANCORP OF NORTH CAROLINA, INC.

## Consolidated Statements of Cash Flows

Nine months ended September 30, 2010 and 2009

(Dollars in thousands)

|  | 2010<br>(Unaudited) | 2009<br>(Unaudited) |
|--|---------------------|---------------------|
| Cash flows from operating activities:  |                     |                     |
| Net earnings   | \$ 2,279            | 2,285               |
| Adjustments to reconcile net earnings to net cash provided by operating activities:      |                     |                     |
| Depreciation, amortization and accretion   | 3,519               | 2,033               |
| Provision for loan losses  | 10,217              | 7,156               |
| Gain on sale of investment securities  | (1,791 )            | (1,795 )            |
| Write-down of investment securities  | 100                 | 723                 |
| Gain on ineffective portion of derivative financial instruments                          | -                   | (25 )               |
| (Gain)/loss on sale of other real estate and repossessions                               | (198 )              | 44                  |
| Write-down of other real estate and repossessions  | 895                 | 477                 |
| Restricted stock expense   | 7                   | -                   |
| Change in:   |                     |                     |
| Mortgage loans held for sale   | 726                 | (1,577 )            |
| Cash surrender value of life insurance   | (193 )              | (197 )              |
| Other assets   | (643 )              | (2,853 )            |
| Other liabilities  | (357 )              | 88                  |
| Net cash provided by operating activities  | 14,561              | 6,359               |
| Cash flows from investing activities:  |                     |                     |
| Net change in certificates of deposit  | 2,610               | -                   |
| Purchases of investment securities available for sale                                    | (133,646 )          | (128,710 )          |
| Proceeds from calls, maturities and paydowns of investment securities available for sale | 77,070              | 35,361              |
| Proceeds from sales of investment securities available for sale                          | 28,077              | 30,743              |
| Purchases of other investments   | -                   | (1,176 )            |
| Proceeds from sale of other investments  | 393                 | 788                 |
| Net change in loans  | 22,338              | (6,361 )            |
| Purchases of premises and equipment  | (1,148 )            | (693 )              |
| Proceeds from sale of premises and equipment   | -                   | 1                   |
| Proceeds from sale of other real estate and repossessions                                | 4,681               | 1,072               |

|   |           |           |
|---|-----------|-----------|
| Net cash provided (used) by investing activities            | 375       | (68,975 ) |
| Cash flows from financing activities:                       |           |           |
| Net change in deposits                                      | 32,962    | 73,256    |
| Net change in demand notes payable to U.S. Treasury         | (284 )    | (1,156 )  |
| Net change in securities sold under agreement to repurchase | 4,634     | (5,590 )  |
| Proceeds from FHLB borrowings                               | -         | 24,100    |
| Repayments of FHLB borrowings                               | (7,000 )  | (24,100 ) |
| Proceeds from FRB borrowings                                | -         | 45,000    |
| Repayments of FRB borrowings                                | -         | (37,500 ) |
| Cash dividends paid on Series A preferred stock             | (940 )    | (807 )    |
| Cash dividends paid on common stock                         | (337 )    | (1,329 )  |
| Net cash provided by financing activities                   | 29,035    | 71,874    |
| Net change in cash and cash equivalent                      | 43,971    | 9,258     |
| Cash and cash equivalents at beginning of period            | 31,340    | 27,929    |
| Cash and cash equivalents at end of period                  | \$ 75,311 | 37,187    |

## PEOPLES BANCORP OF NORTH CAROLINA, INC.

## Consolidated Statements of Cash Flows, continued

Nine months ended September 30, 2010 and 2009

(Dollars in thousands)

|  | 2010<br>(Unaudited) | 2009<br>(Unaudited) |
|--|---------------------|---------------------|
| <b>Supplemental disclosures of cash flow information:</b>                  |                     |                     |
| Cash paid during the year for:   |                     |                     |
| Interest   | \$ 11,146           | 13,434              |
| Income taxes   | \$ 1,700            | 1,483               |
| Noncash investing and financing activities:                                |                     |                     |
| Change in unrealized gain on investment securities available for sale, net |                     |                     |
|  | \$ (2,578 )         | (142 )              |
| Change in unrealized gain on derivative financial instruments, net         |                     |                     |
|  | \$ 445              | (1,636 )            |
| Transfer of loans to other real estate and repossessions                   | \$ 6,189            | 3,387               |
| Financed portion of sale of other real estate                              | \$ 1,703            | 818                 |
| Accretion of Series A preferred stock                                      | \$ 106              | 91                  |

See accompanying notes to consolidated financial statements.

PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(1) Summary of Significant Accounting Policies

The consolidated financial statements include the financial statements of Peoples Bancorp of North Carolina, Inc. and its wholly owned subsidiaries, Peoples Bank (the "Bank") and Community Bank Real Estate Solutions, LLC, along with the Bank's wholly owned subsidiaries, Peoples Investment Services, Inc. and Real Estate Advisory Services, Inc. (collectively called the "Company"). All significant intercompany balances and transactions have been eliminated in consolidation.

The consolidated financial statements in this report are unaudited. In the opinion of management, all adjustments (none of which were other than normal accruals) necessary for a fair presentation of the financial position and results of operations for the periods presented have been included. Management of the Company has made a number of estimates and assumptions relating to reporting of assets and liabilities and the disclosure of contingent assets and liabilities to prepare these consolidated financial statements in conformity with accounting principles generally accepted in the United States. Actual results could differ from those estimates.

The Company's accounting policies are fundamental to understanding management's discussion and analysis of results of operations and financial condition. Many of the Company's accounting policies require significant judgment regarding valuation of assets and liabilities and/or significant interpretation of the specific accounting guidance. A description of the Company's significant accounting policies can be found in Note 1 of the notes to consolidated financial statements in the Company's 2009 Annual Report to Shareholders which is Appendix A to the Proxy Statement for the May 6, 2010 Annual Meeting of Shareholders.

Recently Issued Accounting Pronouncements

In February 2010, the FASB issued Accounting Standards Update No. 2010-09, Subsequent Events: Amendments to Certain Recognition and Disclosure Requirements ("ASU No. 2010-09"). ASU No. 2010-09 removes some contradictions between the requirements of U.S. GAAP and the filing rules of the Securities and Exchange Commission ("SEC"). SEC filers are required to evaluate subsequent events through the date the financial statements are issued, and they are no longer required to disclose the date through which subsequent events have been evaluated. This guidance was effective upon issuance except for the use of the issued date for conduit debt obligors, and it is not expected to have a material impact on the Company's results of operations, financial position or disclosures.

In February 2010, the FASB issued Accounting Standards Update No. 2010-10, Consolidation: Amendments for Certain Investment Funds ("ASU No. 2010-10"). ASU No. 2010-10 indefinitely defers the effective date for certain investment funds, the amendments made to FASB ASC 810-10 related to variable interest entities by Statement of Financial Accounting Standard ("SFAS") No. 167, however this deferral does not apply to the disclosure requirements of SFAS No. 167. ASU No. 2010-10 also clarifies that (1) interests of related parties must be considered in determining whether fees paid to decision makers or service providers constitute a variable interest, and (2) a quantitative calculation should not be the only basis on which such determination is made. This guidance is effective as of the beginning of the first annual period beginning after November 15, 2009, and for interim periods within that first annual reporting period. It is not expected to have a material impact on the Company's results of operations, financial position or disclosures.

In March 2010, the FASB issued Accounting Standards Update No. 2010-11, Derivatives and Hedging: Scope Exception Related to Embedded Credit Derivatives ("ASU No. 2010-11"). ASU No. 2010-11 clarifies the type of

embedded credit derivative that is exempt from embedded derivative bifurcation requirements by resolving a potential ambiguity about the breadth of the embedded credit derivative scope exception with regard to some types of contracts, such as collateralized debt obligations ("CDO's") and synthetic CDO's. The scope exception will no longer apply to some contracts that contain an embedded credit derivative feature that transfers credit risk. The ASU is effective for fiscal quarters beginning after June 15, 2010, and is not expected to have a material impact on the Company's results of operations, financial position or disclosures.

In July 2010, the FASB issued Accounting Standards Update No. 2010-20, Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses ("ASU No. 2010-20"). ASU No. 2010-20 will expand loan credit quality and allowance for loan losses disclosure requirements. The ASU is effective for fiscal quarters ending on or after December 15, 2010, and is not expected to have a material impact on the Company's results of operations or financial position; however, additional disclosures will be required for this ASU.

Other accounting standards that have been issued or proposed by the FASB or other standards-setting bodies are not expected to have a material impact on the Company's results of operations, financial position or disclosures.

(2) Investment Securities

Investment securities available for sale at September 30, 2010 and December 31, 2009 are as follows:

(Dollars in thousands)

|  | Amortized<br>Cost | September 30, 2010           |                               | Estimated<br>Fair Value |
|--|-------------------|------------------------------|-------------------------------|-------------------------|
|  |                   | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses |                         |
| Mortgage-backed securities               | \$ 101,829        | 2,416                        | 228                           | 104,017                 |
| U.S. government<br>sponsored enterprises | 45,318            | 1,918                        | -                             | 47,236                  |
| State and political subdivisions         | 70,718            | 3,089                        | 12                            | 73,795                  |
| Trust preferred securities               | 1,250             | -                            | -                             | 1,250                   |
| Equity securities                        | 1,174             | 234                          | 197                           | 1,211                   |
| Total                                    | \$ 220,289        | 7,657                        | 437                           | 227,509                 |

|  | Amortized<br>Cost | December 31, 2009            |                               | Estimated<br>Fair Value |
|--|-------------------|------------------------------|-------------------------------|-------------------------|
|  |                   | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses |                         |
| Mortgage-backed securities               | \$ 105,915        | 1,830                        | 219                           | 107,526                 |
| U.S. government<br>sponsored enterprises | 40,259            | 934                          | 51                            | 41,142                  |
| State and political subdivisions         | 43,460            | 1,065                        | 189                           | 44,336                  |
| Trust preferred securities               | 1,250             | -                            | -                             | 1,250                   |
| Equity securities                        | 1,233             | -                            | 372                           | 861                     |
| Total                                    | \$ 192,117        | 3,829                        | 831                           | 195,115                 |

The current fair value and associated unrealized losses on investments in securities with unrealized losses at September 30, 2010 and December 31, 2009 are summarized in the tables below, with the length of time the individual securities have been in a continuous loss position.

(Dollars in thousands)

|                            | Less than 12 Months |                      | September 30, 2010<br>12 Months or More |                      | Fair<br>Value | Total<br>Unrealized<br>Losses |
|----------------------------|---------------------|----------------------|---|----------------------|---------------|-------------------------------|
|                            | Fair Value          | Unrealized<br>Losses | Fair<br>Value                           | Unrealized<br>Losses |               |                               |
| Mortgage-backed securities | \$ 21,660           | 218                  | 1,076                                   | 10                   | 22,736        | 228                           |
|                            | 2,386               | 12                   | -                                       | -                    | 2,386         | 12                            |



State and political  
subdivisions

|                   |           |     |       |     |        |     |
|-------------------|-----------|-----|-------|-----|--------|-----|
| Equity securities | -         | -   | 403   | 197 | 403    | 197 |
| Total             | \$ 24,046 | 230 | 1,479 | 207 | 25,525 | 437 |

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(Dollars in thousands)

|                                       | Less than 12 Months |                   | December 31, 2009<br>12 Months or More |                   | Total         |                   |
|---------------------------------------|---------------------|-------------------|--|-------------------|---------------|-------------------|
|                                       | Fair Value          | Unrealized Losses | Fair Value                             | Unrealized Losses | Fair Value    | Unrealized Losses |
| Mortgage-backed securities            | \$ 16,970           | 219               | -                                      | -                 | 16,970        | 219               |
| U.S. government sponsored enterprises | 8,683               | 51                | -                                      | -                 | 8,683         | 51                |
| State and political subdivisions      | 9,249               | 182               | 153                                    | 7                 | 9,402         | 189               |
| Equity securities                     | -                   | -                 | 861                                    | 372               | 861           | 372               |
| <b>Total</b>                          | <b>\$ 34,902</b>    | <b>452</b>        | <b>1,014</b>                           | <b>379</b>        | <b>35,916</b> | <b>831</b>        |

At September 30, 2010, unrealized losses in the investment securities portfolio relating to debt securities totaled \$240,000. The unrealized losses on these debt securities arose due to changing interest rates and are considered to be temporary. From the September 30, 2010 tables above, three out of 132 securities issued by state and political subdivisions contained unrealized losses and 14 out of 104 securities issued by U.S. government sponsored enterprises, including mortgage-backed securities, contained unrealized losses. These unrealized losses are considered temporary because of acceptable investment grades on each security and the repayment sources of principal and interest are government backed.

The Company periodically evaluates its investments for any impairment which would be deemed other than temporary. As part of its evaluation during second quarter 2010, the Company determined that the fair value of one investment was less than the original cost of the investment and that the decline in fair value was not temporary in nature. As a result, the Company wrote down its original investments by \$100,000 during second quarter 2010. The remaining fair value of the investment at September 30, 2010 was less than \$1,000. Similarly, as part of its evaluation in 2009, the Company wrote-down three investments by \$723,000. The remaining fair value of the investments at December 31, 2009 was \$11,000.

The amortized cost and estimated fair value of investment securities available for sale at September 30, 2010, by contractual maturity, are shown below. Expected maturities of mortgage-backed securities will differ from contractual maturities because borrowers have the right to call or prepay obligations with or without call or prepayment penalties.

(Dollars in thousands)

|                            | Amortized Cost    | Estimated Fair Value |
|----------------------------|-------------------|----------------------|
| Due within one year        | \$ 2,222          | 2,256                |
| Due from one to five years | 31,552            | 32,880               |
| Due from five to ten years | 31,943            | 32,952               |
| Due after ten years        | 51,569            | 53,442               |
| Mortgage-backed securities | 101,829           | 104,768              |
| Equity securities          | 1,174             | 1,211                |
| <b>Total</b>               | <b>\$ 220,289</b> | <b>227,509</b>       |

Proceeds from sales of securities available for sale during the nine months ended September 30, 2010 were \$28.0 million and resulted in a gross gain of \$1.8 million. During the nine months ended September 30, 2009, the proceeds from sales of securities available for sale were \$30.7 million and resulted in a gross gain of \$1.8 million.

Securities with a fair value of approximately \$73.5 million and \$69.6 million at September 30, 2010 and December 31, 2009, respectively, were pledged to secure public deposits and for other purposes as required by law.

## (3) Allowance for Loan Losses

The following is an analysis of the allowance for loan losses for the nine months ended September 30, 2010 and 2009:

| (Dollars in thousands)       | 2010      | 2009     |
|------------------------------|-----------|----------|
| Balance, beginning of period | \$ 15,413 | 11,026   |
| Provision for loan losses    | 10,217    | 7,156    |
| Less:                        |           |          |
| Charge-offs                  | (8,362 )  | (3,166 ) |
| Recoveries                   | 450       | 458      |
| Net charge-offs              | (7,912 )  | (2,708 ) |
| Balance, end of period       | \$ 17,718 | 15,474   |

## (4) Net Earnings Per Common Share

Net earnings per common share is based on the weighted average number of common shares outstanding during the period while the effects of potential common shares outstanding during the period are included in diluted earnings per common share. The average market price during the year is used to compute equivalent shares.

The reconciliation of the amounts used in the computation of both “basic earnings per common share” and “diluted earnings per common share” for the three and nine months ended September 30, 2010 and 2009 is as follows:

For the three months ended September 30, 2010

|                                   | Net Earnings<br>Available to<br>Common<br>Shareholders<br>(Dollars in<br>thousands) | Common<br>Shares | Per Share<br>Amount |
|-----------------------------------|---|------------------|---------------------|
| Basic earnings per common share   | \$ 192  | 5,539,056        | \$ 0.03             |
| Effect of dilutive securities:    |   |                  |                     |
| Stock options                     | -   | 2,768            |                     |
| Diluted earnings per common share | \$ 192  | 5,541,824        | \$ 0.03             |

For the nine months ended September 30, 2010

|                                 | Net Earnings<br>Available to<br>Common<br>Shareholders<br>(Dollars in<br>thousands) | Common<br>Shares | Per Share<br>Amount |
|---------------------------------|---|------------------|---------------------|
| Basic earnings per common share | \$ 1,234  | 5,539,056        | \$ 0.22             |
| Effect of dilutive securities:  |   |                  |                     |
| Stock options                   | -   | 4,480            |                     |

|                                   |    |       |           |    |      |
|-----------------------------------|----|-------|-----------|----|------|
| Diluted earnings per common share | \$ | 1,234 | 5,543,536 | \$ | 0.22 |
|-----------------------------------|----|-------|-----------|----|------|

For the three months ended September 30, 2009

|  | Net Earnings<br>(Loss) Available to<br>Common<br>Shareholders<br>(Dollars in<br>thousands) | Common<br>Shares | Per Share<br>Amount |
|--|--|------------------|---------------------|
| Basic earnings (loss) per common share   | \$ (48 )   | 5,539,056        | \$ (0.01 )          |
| Effect of dilutive securities:           |  |                  |                     |
| Stock options                            | -  | 3,526            |                     |
| Diluted earnings (loss) per common share | \$ (48 )   | 5,542,582        | \$ (0.01 )          |

For the nine months ended September 30, 2009

|                                   | Net Earnings<br>Available to<br>Common<br>Shareholders<br>(Dollars in<br>thousands) | Common<br>Shares | Per Share<br>Amount |
|-----------------------------------|---|------------------|---------------------|
| Basic earnings per common share   | \$ 1,387  | 5,539,056        | \$ 0.25             |
| Effect of dilutive securities:    |   |                  |                     |
| Stock options                     | -   | 3,346            |                     |
| Diluted earnings per common share | \$ 1,387  | 5,542,402        | \$ 0.25             |

#### (5) Stock-Based Compensation

The Company has an Omnibus Stock Ownership and Long Term Incentive Plan (the "1999 Plan") whereby certain stock-based rights, such as stock options, restricted stock, performance units, stock appreciation rights, or book value shares, may be granted to eligible directors and employees. The 1999 Plan expired on May 13, 2009.

Under the 1999 Plan, the Company granted incentive stock options to certain eligible employees in order that they may purchase Company stock at a price equal to the fair market value on the date of the grant. The options granted in 1999 vested over a five-year period. Options granted subsequent to 1999 vested over a three-year period. All options expire ten years after issuance. The Company did not grant any options during the nine months ended September 30, 2010.

The Company granted 3,000 shares of restricted stock in 2007 at a grant date fair value of \$17.40 per share. The Company granted 1,750 shares of restricted stock at a grant date fair value of \$12.80 per share during third quarter 2008 and 2,000 shares of restricted stock at a fair value of \$11.37 per share during fourth quarter 2008. The Company recognizes compensation expense on the restricted stock over the period of time the restrictions are in place (three years from the grant date for the grants to date). The amount of expense recorded each period reflects the changes in the Company's stock price during the period. As of September 30, 2010, there was \$5,000 of total unrecognized compensation cost related to restricted stock grants, which is expected to be recognized over a period of approximately one year.

The Company also has an Omnibus Stock Ownership and Long Term Incentive Plan that was approved by shareholders' on May 7, 2009 (the "2009 Plan") whereby certain stock-based rights, such as stock options, restricted stock, performance units, stock appreciation rights, or book value shares, may be granted to eligible directors and employees. A total of 360,000 shares are currently reserved for possible issuance under the 2009 Plan. All rights must be granted or awarded within ten years from the May 7, 2009 effective date of the 2009 Plan. The Company has not granted any rights under this plan.

(6) Fair Value

The Company is required to disclose fair value information about financial instruments, whether or not recognized on the face of the balance sheet, for which it is practicable to estimate that value. The assumptions used in the estimation of the fair value of the Company's financial instruments are detailed below. Where quoted prices are not available, fair values are based on estimates using discounted cash flows and other valuation techniques. The

use of discounted cash flows can be significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. The following disclosures should not be considered a surrogate of the liquidation value of the Company, but rather a good faith estimate of the increase or decrease in value of financial instruments held by the Company since purchase, origination, or issuance.

#### Cash and Cash Equivalents

For cash, due from banks and interest bearing deposits, the carrying amount is a reasonable estimate of fair value.

#### Certificates of Deposit

The carrying amount of certificates of deposit is a reasonable estimate of fair value.

#### Investment Securities Available for Sale

Fair values for investment securities are based on quoted market prices.

#### Other Investments

For other investments, the carrying value is a reasonable estimate of fair value.

#### Mortgage Loans Held for Sale

Mortgage loans held for sale are carried at lower of aggregate cost or market value. The cost of mortgage loans held for sale approximates the market value.

#### Loans

The fair value of fixed rate loans is estimated by discounting the future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings. For variable rate loans, the carrying amount is a reasonable estimate of fair value.

#### Cash Surrender Value of Life Insurance

For cash surrender value of life insurance, the carrying value is a reasonable estimate of fair value.

#### Derivative Instruments

For derivative instruments, fair value is estimated as the amount that the Company would receive or pay to terminate the contracts at the reporting date, taking into account the current unrealized gains or losses on open contracts.

#### Deposits and Demand Notes Payable

The fair value of demand deposits, interest-bearing demand deposits, savings, and demand notes payable to U.S. Treasury is the amount payable on demand at the reporting date. The fair value of certificates of deposit is estimated by discounting the future cash flows using the rates currently offered for deposits of similar remaining maturities.

#### Securities Sold Under Agreements to Repurchase

For securities sold under agreements to repurchase, the carrying value is a reasonable estimate of fair value.

#### FHLB Borrowings

The fair value of FHLB borrowings is estimated based upon discounted future cash flows using a discount rate comparable to the current market rate for such borrowings.

#### Junior Subordinated Debentures

Because the Company's junior subordinated debentures were issued at a floating rate, the carrying amount is a reasonable estimate of fair value.



**Commitments to Extend Credit and Standby Letters of Credit**

Commitments to extend credit and standby letters of credit are generally short-term and at variable interest rates. Therefore, both the carrying value and estimated fair value associated with these instruments are immaterial.

**Limitations**

Fair value estimates are made at a specific point in time, based on relevant market information and information about the financial instrument. These estimates do not reflect any premium or discount that

could result from offering for sale at one time the Company's entire holdings of a particular financial instrument. Because no market exists for a significant portion of the Company's financial instruments, fair value estimates are based on many judgments. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

Fair value estimates are based on existing on and off-balance sheet financial instruments without attempting to estimate the value of anticipated future business and the value of assets and liabilities that are not considered financial instruments. Significant assets and liabilities that are not considered financial instruments include the deferred income taxes and premises and equipment. In addition, the tax ramifications related to the realization of the unrealized gains and losses can have a significant effect on fair value estimates and have not been considered in the estimates.

GAAP establishes a framework for measuring fair value and expands disclosures about fair value measurements.

There is a three-level fair value hierarchy for fair value measurements. Level 1 inputs are quoted prices in active markets for identical assets or liabilities that a company has the ability to access at the measurement date. Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. Level 3 inputs are unobservable inputs for the asset or liability. The table below presents the balance of securities available for sale and derivatives, which are measured at fair value on a recurring basis by level within the fair value hierarchy as of September 30, 2010.

(Dollars in thousands)

|   | Fair Value<br>Measurements<br>September 30, 2010 | Level 1<br>Valuation | Level 2<br>Valuation | Level 3<br>Valuation |
|---|--|----------------------|----------------------|----------------------|
| Mortgage-backed securities                    | \$ 104,017                                       | -                    | 104,017              | -                    |
| U.S. government<br>sponsored enterprises      | \$ 47,236  | -                    | 47,236               | -                    |
| State and political subdivisions              | \$ 73,795  | -                    | 73,795               | -                    |
| Trust preferred securities                    | \$ 1,250   | -                    | -                    | 1,250                |
| Equity securities                             | \$ 1,211   | 1,211                | -                    | -                    |
| Mortgage loans held for sale                  | \$ 2,114   | -                    | 2,114                | -                    |
| Market value of derivatives (in other assets) | \$ 1,033   | -                    | 1,033                | -                    |

The following is an analysis of fair value measurements of investment securities available for sale using Level 3, significant unobservable inputs, for the nine months ended September 30, 2010:

(Dollars in thousands)

|   | Investment Securities<br>Available for Sale<br>Level 3 Valuation |
|---|--|
| Balance, beginning of period                                      | \$ 1,250   |
| Change in book value  | -  |
| Change in gain/(loss) realized and unrealized                     | -  |
| Purchases/(sales)   | -  |
| Transfers in and/or out of Level 3                                | -  |
| Balance, end of period  | \$ 1,250   |
| Change in unrealized gain/(loss) for assets still held in Level 3 | \$ -   |

The Company's September 30, 2010 fair value measurement for impaired loans and other real estate on a non-recurring basis is presented below:

(Dollars in thousands)

|                   | Fair Value<br>Measurements<br>September 30, 2010 | Level 1<br>Valuation | Level 2<br>Valuation | Level 3<br>Valuation | Total Losses for the<br>Nine Months Ended<br>September 30, 2010 |
|-------------------|--|----------------------|----------------------|----------------------|---|
| Impaired loans    | \$ 38,661  | -                    | 8,430                | 30,231               | (3,725 )  |
| Other Real Estate | \$ 4,804   | -                    | 4,804                | -                    | (659 )  |

The carrying amount and estimated fair value of the Company's financial instruments at September 30, 2010 and December 31, 2009 are as follows:

| (dollars in thousands)                   | September 30, 2010 |                      | December 31, 2009 |                      |
|--|--------------------|----------------------|-------------------|----------------------|
|  | Carrying Amount    | Estimated Fair Value | Carrying Amount   | Estimated Fair Value |
| <b>Assets:</b>                           |                    |                      |                   |                      |
| Cash and cash equivalents                | \$ 75,311          | 75,311               | 31,340            | 31,340               |
| Certificates of deposit                  | \$ 735             | 735                  | 3,345             | 3,345                |
| Investment securities available for sale | \$ 227,509         | 227,509              | 195,115           | 195,115              |
| Other investments                        | \$ 5,953           | 5,953                | 6,346             | 6,346                |
| Mortgage loans held for sale             | \$ 2,114           | 2,114                | 2,840             | 2,840                |
| Loans, net                               | \$ 725,606         | 726,472              | 762,643           | 763,939              |
| Cash surrender value of life insurance   | \$ 7,475           | 7,475                | 7,282             | 7,282                |
| Derivative instruments                   | \$ 1,033           | 1,033                | 1,762             | 1,762                |
| <b>Liabilities:</b>                      |                    |                      |                   |                      |
| Deposits and demand notes payable        | \$ 842,657         | 841,563              | 809,979           | 809,717              |
| Securities sold under agreements         |                    |                      |                   |                      |
| to repurchase                            | \$ 41,510          | 41,510               | 36,876            | 36,876               |
| FHLB borrowings                          | \$ 70,000          | 83,615               | 77,000            | 86,680               |
| Junior subordinated debentures           | \$ 20,619          | 20,619               | 20,619            | 20,619               |

#### (7) Derivative Instruments and Hedging Activities

##### Accounting Policy for Derivative Instruments and Hedging Activities

The disclosure requirements for derivatives and hedging activities have the intent to provide users of financial statements with an enhanced understanding of: (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for and (c) how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. The disclosure requirements include qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about the fair value of and gains and losses on derivative instruments, and disclosures about credit-risk-related contingent features in derivative instruments.

The Company records all derivatives on the balance sheet at fair value. The accounting for changes in the fair value of derivatives depends on the intended use of the derivative, whether the Company has elected to designate a derivative in a hedging relationship and apply hedge accounting and whether the hedging relationship has satisfied the criteria necessary to apply hedge accounting. Derivatives designated and qualifying as a hedge of the exposure to changes in the fair value of an asset, liability, or firm commitment attributable to a particular risk, such as interest rate risk, are considered fair value hedges. Derivatives designated and qualifying as a hedge of the exposure to variability in expected future cash flows, or other types of forecasted transactions, are considered cash flow hedges. Hedge accounting generally provides for the matching of the timing of gain or loss recognition on the hedging instrument with the recognition of the changes in the fair value of the hedged asset or liability that are attributable to the hedged risk in a fair value hedge or the earnings effect of the hedged forecasted transactions in a cash flow hedge. The Company may enter into derivative contracts that are intended to economically hedge certain of its risks, even though hedge accounting does not apply or the Company elects not to apply hedge accounting.

#### Risk Management Objective of Using Derivatives

The Company has an overall interest rate risk management strategy that incorporates the use of derivative instruments to minimize significant unplanned fluctuations in earnings that are caused by interest rate volatility. By using derivative instruments, the Company is exposed to credit and market risk. If the counterparty fails to perform, credit risk is equal to the extent of the fair-value gain in the derivative. The Company minimizes the credit risk in derivative instruments by entering into transactions with high-quality counterparties that are reviewed periodically by the Company. As of September 30, 2010, the Company had one interest rate swap with a notional amount of \$50.0 million that was designated as a cash flow hedge of interest rate risk.

#### Fair Values of Derivative Instruments on the Balance Sheet

The table below presents the fair value of the Company's derivative financial instruments as well as their classification on the Balance Sheet as of September 30, 2010 and December 31, 2009.

(Dollars in thousands)

|                                    | Asset Derivatives        |            |                         |            |
|------------------------------------|--------------------------|------------|-------------------------|------------|
|                                    | As of September 30, 2010 |            | As of December 31, 2009 |            |
|                                    | Balance Sheet            | Fair Value | Balance Sheet           | Fair Value |
|                                    | Location                 |            | Location                |            |
| Interest rate derivative contracts | Other assets             | \$ 1,033   | Other assets            | \$ 1,762   |

#### Cash Flow Hedges of Interest Rate Risk

The Company's objectives in using interest rate derivatives are to add stability to interest income and expense and to manage its exposure to interest rate movements. To accomplish this objective, the Company primarily uses interest rate swaps and floors as part of its interest rate risk management strategy. For hedges of the Company's variable-rate loan assets, interest rate swaps designated as cash flow hedges involve the receipt of fixed-rate amounts from a counterparty in exchange for the Company making variable-rate payments over the life of the agreements without exchange of the underlying notional amount. For hedges of the Company's variable-rate loan assets, the interest rate floors designated as a cash flow hedge involves the receipt of variable-rate amounts from a counterparty if interest rates fall below the strike rate on the contract in exchange for an up front premium. As of September 30, 2010, the Company had one interest rate swap with a notional amount of \$50.0 million that was designated as a cash flow hedge of interest rate risk.

The effective portion of changes in the fair value of derivatives designated and that qualify as cash flow hedges is recorded in Accumulated Other Comprehensive Income and is subsequently reclassified into earnings in the period that the hedged forecasted transaction affects earnings. During 2010, such derivatives were used to hedge the variable cash inflows associated with existing pools of prime-based loan assets. The ineffective portion of the change in fair value of the derivatives is recognized directly in earnings. The Company's derivatives did not have any hedge ineffectiveness recognized in earnings during the nine months ended September 30, 2010 and 2009.

Amounts reported in accumulated other comprehensive income related to derivatives will be reclassified to interest income or expense as interest payments are received/made on the Company's variable-rate assets/liabilities. During the next twelve months, the Company estimates that \$1.0 million will be reclassified as an increase to interest income.

#### Effect of Derivative Instruments on the Income Statement

The table below presents the effect of the Company's derivative financial instruments on the Income Statement for the nine months ended September 30, 2010 and 2009.

(Dollars in thousands)

|                                    | Amount of Gain                          |        | Location of Gain (Loss)     | Amount of Gain              |          |
|------------------------------------|---|--------|-----------------------------|-----------------------------|----------|
|                                    | (Loss) Recognized in OCI on Derivatives |        | Reclassified from           | Reclassified from           |          |
|                                    | Nine months ended September 30,         |        | Accumulated OCI into Income | Accumulated OCI into Income |          |
|                                    | 2010                                    | 2009   |                             | 2010                        | 2009     |
| Interest rate derivative contracts | \$ 407                                  | \$ 342 | Interest income             | \$ 1,136                    | \$ 2,588 |
|                                    |   |        |                             | \$ -                        | \$ 48    |

Non-interest  
income

Subsequent Events

The Company has reviewed and evaluated subsequent events and transactions for material subsequent events through the date the financial statements are issued.

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

The following is a discussion of our financial position and results of operations and should be read in conjunction with the information set forth under Item 1A Risk Factors and the Company's consolidated financial statements and notes thereto on pages A-32 through A-66 of the Company's 2009 Annual Report to Shareholders which is Appendix A to the Proxy Statement for the May 6, 2010 Annual Meeting of Shareholders.

### Introduction

Management's discussion and analysis of earnings and related data are presented to assist in understanding the consolidated financial condition and results of operations of Peoples Bancorp of North Carolina, Inc ("the Company"). Peoples Bancorp is the parent company of Peoples Bank (the "Bank") and a registered bank holding company operating under the supervision of the Board of Governors of the Federal Reserve System (the "Federal Reserve"). The Bank is a North Carolina-chartered bank, with offices in Catawba, Lincoln, Alexander, Mecklenburg, Iredell, Union and Wake counties, operating under the banking laws of North Carolina and the rules and regulations of the Federal Deposit Insurance Corporation (the "FDIC").

### Overview

Our business consists principally of attracting deposits from the general public and investing these funds in commercial loans, real estate mortgage loans, real estate construction loans and consumer loans. Our profitability depends primarily on our net interest income, which is the difference between the income we receive on our loan and investment securities portfolios and our cost of funds, which consists of interest paid on deposits and borrowed funds. Net interest income also is affected by the relative amounts of interest-earning assets and interest-bearing liabilities. When interest-earning assets approximate or exceed interest-bearing liabilities, any positive interest rate spread will generate net interest income. Our profitability is also affected by the level of other income and operating expenses. Other income consists primarily of miscellaneous fees related to our loans and deposits, mortgage banking income and commissions from sales of annuities and mutual funds. Operating expenses consist of compensation and benefits, occupancy related expenses, federal deposit and other insurance premiums, data processing, advertising and other expenses.

Our operations are influenced significantly by local economic conditions and by policies of financial institution regulatory authorities. The earnings on our assets are influenced by the effects of, and changes in, trade, monetary and fiscal policies and laws, including interest rate policies of the Federal Reserve, inflation, interest rates, market and monetary fluctuations. Lending activities are affected by the demand for commercial and other types of loans, which in turn is affected by the interest rates at which such financing may be offered. Our cost of funds is influenced by interest rates on competing investments and by rates offered on similar investments by competing financial institutions in our market area, as well as general market interest rates. These factors can cause fluctuations in our net interest income and other income. In addition, local economic conditions can impact the credit risk of our loan portfolio, in that (1) local employers may be required to eliminate employment positions of individual borrowers and (2) commercial borrowers may experience a downturn in their operating performance and become unable to make timely payments on their loans. Management evaluates these factors in estimating its allowance for loan losses, and changes in these economic conditions could result in increases or decreases to the provision for loan losses.

Economic conditions in 2010 continue to have a negative impact on our financial condition and results of operations. Unfavorable trends, such as increased unemployment, falling real estate prices, increased loan default and increased bankruptcy rates, have created the difficult business conditions that are affecting the general economy and therefore our operating results. The unemployment rates in our primary market area continue to be higher than state and national averages.



On July 21, 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act") into law. This new legislation makes extensive changes to the laws regulating financial products and services as well as firms and companies offering financial products and services. The Act also alters certain corporate governance matters affecting public companies. The legislation requires substantial rulemaking and mandates numerous additional studies, the results of which could impact future legislative and regulatory action. We are in the process of evaluating this new legislation and determining the extent to which it will impact our current and future operations. Among other things that could have an impact on our operations and activities, the Act (i) amends the manner for calculating the assessment base for deposit insurance premiums paid to the FDIC; (ii) requires the federal banking agencies to issue new rules to implement new minimum leverage and risk-based capital requirements for insured depository institutions; and (iii) requires the Securities and Exchange Commission to complete studies and develop rules or approve stock exchange rules regarding various investor protection issues, including shareholder access to the proxy process, and various matters pertaining to executive compensation and compensation committee oversight. Additionally, the Act establishes the Consumer Financial Protection Bureau ("Bureau") as a new, independent federal agency, which will have broad rulemaking, supervisory and enforcement authority over financial institutions providing consumer financial products and services. Examples of such products and services include deposit products, residential mortgages, home-equity loans and credit cards. Under the Act,

states are permitted to adopt more stringent consumer protection laws, and state attorneys general can enforce those laws as well as consumer protection rules issued by the Bureau. While we are unable to determine all ramifications of the Act at this time, we do anticipate additional non-interest expenses associated with the requirements to comply with this new legislation.

Although we are unable to control the external factors that influence our business, by maintaining high levels of balance sheet liquidity, managing our interest rate exposures and by actively monitoring asset quality, we seek to minimize the potentially adverse risks of unforeseen and unfavorable economic trends.

Our business emphasis has been to operate as a well-capitalized, profitable and independent community-oriented financial institution dedicated to providing quality customer service. We are committed to meeting the financial needs of the communities in which we operate. We believe that we can be more effective in servicing our customers than many of our non-local competitors because of our ability to quickly and effectively provide senior management responses to customer needs and inquiries. Our ability to provide these services is enhanced by the stability of our senior management team.

The Federal Reserve has maintained the Federal Funds Rate at 0.25% since December 2008. This historically low rate has had a negative impact on earnings and will continue to have a negative impact on the Bank's net interest income in future periods. The negative impact of low interest rates has been partially offset by earnings realized on interest rate contracts utilized by the Company. Additional information regarding the Company's interest rate contracts is provided below in the section entitled "Asset Liability and Interest Rate Risk Management."

On December 23, 2008, the Company entered into a Securities Purchase Agreement ("Purchase Agreement") with the United States Department of the Treasury ("UST"). Under the Purchase Agreement, the Company agreed to issue and sell 25,054 shares of Series A preferred stock and a warrant to purchase 357,234 shares of common stock associated with the Company's participation in the UST's Capital Purchase Program ("CPP") under the Troubled Asset Relief Program ("TARP"). Proceeds from this issuance of preferred shares were allocated between preferred stock and the warrant based on their relative fair values at the time of the sale. Of the \$25.1 million in proceeds, \$24.4 million was allocated to the Series A preferred stock and \$704,000 was allocated to the common stock warrant. The discount recorded on the preferred stock that resulted from allocating a portion of the proceeds to the warrant is being accreted directly to retained earnings over a five-year period applying a level yield. As of September 30, 2010, the Company has accreted a total of \$231,000 of the discount related to the Series A preferred stock. The Company has paid dividends of \$940,000 on the Series A preferred stock during 2010. Cumulative undeclared dividends at September 30, 2010 were \$158,000.

The Series A preferred stock qualifies as Tier 1 capital and will pay cumulative dividends at a rate of 5% per annum for the first five years and 9% per annum thereafter. The Series A preferred stock may be redeemed at the stated amount of \$1,000 per share plus any accrued and unpaid dividends. Under the terms of the original Purchase Agreement, the Company could not redeem the preferred shares until December 23, 2011 unless the total amount of the issuance, \$25.1 million, was replaced with the same amount of other forms of capital that would qualify as Tier 1 capital. However, with the enactment of the American Recovery and Reinvestment Act of 2009 ("ARRA"), the Company can now redeem the preferred shares at any time, if approved by the Company's primary regulator. The Series A preferred stock is non-voting except for class voting rights on matters that would adversely affect the rights of the holders of the Series A preferred stock.

The exercise price of the warrant is \$10.52 per common share and it is exercisable at anytime on or before December 18, 2018.

The Company is subject to the following restrictions while the Series A preferred stock is outstanding: 1) UST approval is required for the Company to repurchase shares of outstanding common stock; 2) the full dividend for the latest completed CPP dividend period must be declared and paid in full before dividends may be paid to common shareholders; 3) UST approval is required for any increase in common dividends per share above the last quarterly dividend of \$0.12 per share paid prior to December 23, 2008; and 4) the Company may not take tax deductions for any senior executive officer whose compensation is above \$500,000. There were additional restrictions on executive compensation added in the ARRA for companies participating in the TARP, including participants in the CPP.

It is the intent of the Company to utilize CPP funds to provide capital to support making loans to qualified borrowers in the Bank's market area. The funds will also be used to absorb losses incurred when modifying loans or making concessions to borrowers in order to keep borrowers out of foreclosure. The Bank is also working with its current builders and contractors to provide financing for potential buyers who may not be able to qualify for financing in the current mortgage market in order to help these customers sell existing single family homes. The Company will also use the CPP capital infusion as additional Tier I capital to protect the Bank from potential losses that may be incurred during this current recessionary period. It is the desire of the Company to repay the CPP funds without raising additional equity capital. The Company anticipates being able to repay the CPP funds from future earnings and existing capital. However,

the funds will not be repaid until economic conditions improve and the Company achieves higher levels of earnings.

The Company continues to face challenges resulting from the impact of the current economy on the housing and real estate markets. The Bank continues to monitor and evaluate all significant loans in its portfolio, and will continue to manage its credit risk exposure with the expectation that stabilization of the real estate market will not occur until late 2011 or 2012. The CPP funds have enhanced our capital position as the Company infused the Bank with \$8.0 million additional regulatory capital. The Company has \$17.4 million available that can be infused into the Bank as additional capital if needed to maintain its position as a well capitalized bank. We anticipate increased loan losses in the short run and have prepared for that expectation. We have experienced people managing our past due loans and foreclosed properties to minimize our potential losses. As the economy recovers, we are positioned to take advantage of all opportunities that present themselves. Over the remainder of the year we anticipate net interest margin improvement as repricing of deposits should exceed repricing of loans. The amount and timing of any future Federal Reserve rate adjustment remains uncertain, and may further impact the Bank if those adjustments are significant.

#### Summary of Significant Accounting Policies

The consolidated financial statements include the financial statements of the Company and its wholly owned subsidiaries, the Bank and Community Bank Real Estate Solutions, LLC, along with the Bank's wholly owned subsidiaries, Peoples Investment Services, Inc. and Real Estate Advisory Services, Inc. (collectively called the "Company"). All significant intercompany balances and transactions have been eliminated in consolidation.

The Company's accounting policies are fundamental to understanding management's discussion and analysis of results of operations and financial condition. Many of the Company's accounting policies require significant judgment regarding valuation of assets and liabilities and/or significant interpretation of specific accounting guidance. A more complete description of the Company's significant accounting policies can be found in Note 1 of the Notes to Consolidated Financial Statements in the Company's 2009 Annual Report to Shareholders which is Appendix A to the Proxy Statement for the May 6, 2010 Annual Meeting of Shareholders.

Many of the Company's assets and liabilities are recorded using various techniques that require significant judgment as to recoverability. The collectibility of loans is reflected through the Company's estimate of the allowance for loan losses. The Company performs periodic and systematic detailed reviews of its lending portfolio to assess overall collectibility. In addition, certain assets and liabilities are reflected at their estimated fair value in the consolidated financial statements. Such amounts are based on either quoted market prices or estimated values derived from dealer quotes used by the Company, market comparisons or internally generated modeling techniques. The Company's internal models generally involve present value of cash flow techniques. The various techniques are discussed in greater detail elsewhere in management's discussion and analysis and the notes to the consolidated financial statements.

There are other complex accounting standards that require the Company to employ significant judgment in interpreting and applying certain of the principles prescribed by those standards. These judgments include, but are not limited to, the determination of whether a financial instrument or other contract meets the definition of a derivative in accordance with GAAP. For a more complete discussion of policies, see the notes to the consolidated financial statements.

The disclosure requirements for derivatives and hedging activities have the intent to provide users of financial statements with an enhanced understanding of: (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for and (c) how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. The disclosure requirements include qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about the fair value of and gains and losses on derivative instruments, and disclosures about credit-risk-related contingent

features in derivative instruments.

The Company records all derivatives on the balance sheet at fair value. The accounting for changes in the fair value of derivatives depends on the intended use of the derivative, whether the Company has elected to designate a derivative in a hedging relationship and apply hedge accounting and whether the hedging relationship has satisfied the criteria necessary to apply hedge accounting. Derivatives designated and qualifying as a hedge of the exposure to changes in the fair value of an asset, liability, or firm commitment attributable to a particular risk, such as interest rate risk, are considered fair value hedges. Derivatives designated and qualifying as a hedge of the exposure to variability in expected future cash flows, or other types of forecasted transactions, are considered cash flow hedges. Hedge accounting generally provides for the matching of the timing of gain or loss recognition on the hedging instrument with the recognition of the changes in the fair value of the hedged asset or liability that are attributable to the hedged risk in a fair value hedge or the earnings effect of the hedged forecasted transactions in a cash flow hedge. The Company may enter into derivative contracts that are intended to economically hedge certain of its risks, even though hedge accounting does not apply or the Company elects not to apply hedge accounting.

The Company has an overall interest rate risk management strategy that incorporates the use of derivative instruments to minimize significant unplanned fluctuations in earnings that are caused by interest rate volatility. By using derivative instruments, the Company is exposed to credit and market risk. If the counterparty fails to perform, credit risk is equal to the extent of the fair-value gain in the derivative. The Company minimizes the credit risk in derivative instruments by entering into transactions with high-quality counterparties that are reviewed periodically by the Company. As of September 30, 2010, the Company had one interest rate swap contract with a notional amount of \$50.0 million that was designated as a cash flow hedge of interest rate risk.

The table below presents the fair value of the Company's derivative financial instruments as well as their classification on the Balance Sheet as of September 30, 2010 and December 31, 2009.

(Dollars in thousands)

|                                    | Asset Derivatives        |            |                         |            |
|------------------------------------|--------------------------|------------|-------------------------|------------|
|                                    | As of September 30, 2010 |            | As of December 31, 2009 |            |
|                                    | Balance Sheet            | Fair Value | Balance Sheet           | Fair Value |
|                                    | Location                 |            | Location                |            |
| Interest rate derivative contracts | Other assets             | \$ 1,033   | Other assets            | \$ 1,762   |

The Company's objectives in using interest rate derivatives are to add stability to interest income and expense and to manage its exposure to interest rate movements. To accomplish this objective, the Company primarily uses interest rate swaps and floors as part of its interest rate risk management strategy. For hedges of the Company's variable-rate loan assets, interest rate swaps designated as cash flow hedges involve the receipt of fixed-rate amounts from a counterparty in exchange for the Company making variable-rate payments over the life of the agreements without exchange of the underlying notional amount. For hedges of the Company's variable-rate loan assets, the interest rate floor designated as a cash flow hedge involves the receipt of variable-rate amounts from a counterparty if interest rates fall below the strike rate on the contract in exchange for an up front premium. As of September 30, 2010, the Company had one interest rate swap with a notional amount of \$50.0 million that was designated as a cash flow hedge of interest rate risk.

The effective portion of changes in the fair value of derivatives designated and that qualify as cash flow hedges is recorded in Accumulated Other Comprehensive Income and is subsequently reclassified into earnings in the period that the hedged forecasted transaction affects earnings. During 2010, such derivatives were used to hedge the variable cash inflows associated with existing pools of prime-based loan assets. The ineffective portion of the change in fair value of the derivatives is recognized directly in earnings. The Company's derivatives did not have any hedge ineffectiveness recognized in earnings during the nine months ended September 30, 2010 and 2009.

Amounts reported in accumulated other comprehensive income related to derivatives will be reclassified to interest income or expense as interest payments are received/made on the Company's variable-rate assets/liabilities. During the next twelve months, the Company estimates that \$1.0 million will be reclassified as an increase to interest income.

The table below presents the effect of the Company's derivative financial instruments on the Income Statement for the nine months ended September 30, 2010 and 2009.

(Dollars in thousands)

| Amount of Gain<br>(Loss) Recognized in | Location of Gain<br>(Loss) | Amount of Gain                       |
|--|----------------------------|--------------------------------------|
|  | Reclassified               | Reclassified from<br>Accumulated OCI |

|                                    | OCI on Derivatives |        | from<br>Accumulated<br>OCI into Income | into Income       |          |
|------------------------------------|--------------------|--------|--|-------------------|----------|
|                                    | Nine months ended  |        |  | Nine months ended |          |
|                                    | September 30,      |        |  | September 30,     |          |
|                                    | 2010               | 2009   |  | 2010              | 2009     |
| Interest rate derivative contracts | \$ 407             | \$ 342 | Interest income                        | \$ 1,136          | \$ 2,588 |
|                                    |                    |        | Non-interest<br>income                 | \$ -              | \$ 48    |

Relating to the post retirement benefit plan, the Company is required to recognize an obligation for either the present value of the entire promised death benefit or the annual “cost of insurance” required to keep the policy in force during the post-retirement years. The Company made a \$467,000 reduction to retained earnings in 2008 pursuant to the guidance of the pronouncement to record the portion of this benefit earned by participants prior to adoption of the pronouncement. In 2009, the Company made a \$358,000 addition to retained earnings to reflect an adjustment of the cumulative effect due to amendments to the individual split-dollar plans implemented during 2009.

GAAP establishes a framework for measuring fair value and expands disclosures about fair value measurements. There is a three-level fair value hierarchy for fair value measurements. Level 1 inputs are quoted prices in active markets for identical assets or liabilities that a company has the ability to access at the measurement date. Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. Level 3 inputs are unobservable inputs for the asset or liability. The table below presents the balance of securities available for sale and derivatives, which are measured at fair value on a recurring basis by level within the fair value hierarchy as of September 30, 2010.

(Dollars in thousands)

|   | Fair Value<br>Measurements<br>September 30, 2010 | Level 1<br>Valuation | Level 2<br>Valuation | Level 3<br>Valuation |
|---|--|----------------------|----------------------|----------------------|
| Mortgage-backed securities                    | \$ 104,017                                       | -                    | 104,017              | -                    |
| U.S. government<br>sponsored enterprises      | \$ 47,236  | -                    | 47,236               | -                    |
| State and political subdivisions              | \$ 73,795  | -                    | 73,795               | -                    |
| Trust preferred securities                    | \$ 1,250   | -                    | -                    | 1,250                |
| Equity securities                             | \$ 1,211   | 1,211                | -                    | -                    |
| Mortgage loans held for sale                  | \$ 2,114   | -                    | 2,114                | -                    |
| Market value of derivatives (in other assets) | \$ 1,033   | -                    | 1,033                | -                    |

Fair values of investment securities available for sale are determined by obtaining quoted prices on nationally recognized securities exchanges when available. If quoted prices are not available, fair value is determined using matrix pricing, which is a mathematical technique used widely in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities. Fair values of derivative instruments are determined using widely accepted valuation techniques including discounted cash flow analysis on the expected cash flows of each derivative. This analysis reflects the contractual terms of the derivatives, including the period to maturity, and uses observable market-based inputs, including interest rate curves and implied volatilities.

The following is an analysis of fair value measurements of investment securities available for sale using Level 3, significant unobservable inputs, for the nine months ended September 30, 2010:

(Dollars in thousands)

|   | Investment Securities Available<br>for Sale<br>Level 3 Valuation |
|---|--|
| Balance, beginning of period                                      | \$ 1,250   |
| Change in book value  | -  |
| Change in gain/(loss) realized and unrealized                     | -  |
| Purchases/(sales)   | -  |
| Transfers in and/or out of Level 3                                | -  |
| Balance, end of period  | \$ 1,250   |
| Change in unrealized gain/(loss) for assets still held in Level 3 | \$ -   |

The Company's September 30, 2010 fair value measurement for impaired loans and other real estate on a non-recurring basis is presented below:



(Dollars in thousands)

|                   | Fair Value<br>Measurements<br>September 30,<br>2010 | Level 1<br>Valuation | Level 2<br>Valuation | Level 3<br>Valuation | Total Losses for the<br>Nine Months<br>Ended September<br>30, 2010 |
|-------------------|---|----------------------|----------------------|----------------------|--|
| Impaired loans    | \$ 38,661   | -                    | 8,430                | 30,231               | (3,725 )   |
| Other Real Estate | \$ 4,804  | -                    | 4,804                | -                    | (659 )   |

At each reporting period, the Company determines which loans are impaired. Accordingly, the Company's impaired loans are reported at their estimated fair value on a non-recurring basis. An allowance for each impaired loan, which are generally collateral-dependent, is calculated based on the fair value of its collateral. The fair value of the

collateral is based on appraisals performed by third-party valuation specialists. Factors including the assumptions and techniques utilized by the appraiser are considered by management. If the recorded investment in the impaired loan exceeds the measure of fair value of the collateral, a valuation allowance is recorded as a component of the allowance for loan losses.

Management of the Company has made a number of estimates and assumptions relating to reporting of assets and liabilities and the disclosure of contingent assets and liabilities to prepare these consolidated financial statements in conformity with GAAP. Actual results could differ from those estimates.

#### Results of Operations

Summary. Net earnings for the third quarter of 2010 were \$540,000, or \$0.10 basic and diluted net earnings per share before adjustment for preferred stock dividends and accretion as compared to \$300,000, or \$0.05 basic and diluted net earnings per share for the same period one year ago. After adjusting for \$348,000 in dividends and accretion on preferred stock, net earnings available to common shareholders for the three months ended September 30, 2010 were \$192,000, or \$0.03 basic and diluted net earnings per common share as compared to \$48,000 net loss available to common shareholders, or \$0.01 basic and diluted net loss per common share for the same period one year ago. The Company recognized a \$479,000 net loss from recurring operations for the three months ended September 30, 2010, or \$0.09 basic and diluted net loss per share, before adjustment for preferred stock dividends and accretion, as compared to third quarter 2009 net earnings from recurring operations of \$670,000, or \$0.12 basic and diluted net earnings per share. The decrease in third quarter recurring earnings is primarily attributable to an increase in provision for loan losses as discussed below.

The annualized return on average assets was 0.20% for the three months ended September 30, 2010 compared to 0.12% for the same period in 2009, and annualized return on average shareholders' equity was 2.09% for the three months ended September 30, 2010 compared to 1.20% for the same period in 2009.

Year-to-date net earnings as of September 30, 2010 and September 30, 2009 were each \$2.3 million, or \$0.41 basic and diluted net earnings per share, before adjustment for preferred stock dividends and accretion. After adjusting for dividends and accretion on preferred stock, net earnings available to common shareholders for the nine months ended September 30, 2010 were \$1.2 million, or \$0.22 basic and diluted net earnings per common share as compared to \$1.4 million, or \$0.25 basic and diluted net earnings per common share, for the same period one year ago. Net earnings from recurring operations for the nine months ended September 30, 2010 were \$1.5 million, or \$0.26 basic and diluted net earnings per share, before adjustment for preferred stock dividends and accretion, as compared to net earnings from recurring operations of \$1.9 million, or \$0.35 basic and diluted net earnings per share, for the same period one year ago. The decrease in year-to-date earnings is primarily attributable to an increase in provision for loan losses, which was partially offset by an increase in net interest income, an increase in recurring non-interest income and a decrease in non-interest expense as discussed below.

The annualized return on average assets was 0.28% for the nine months ended September 30, 2010 compared to 0.30% for the same period in 2009, and annualized return on average shareholders' equity was 2.98% for the nine months ended September 30, 2010 compared to 3.03% for the same period in 2009.

Net Interest Income. Net interest income, the major component of the Company's net earnings, was \$8.5 million for the three months ended September 30, 2010 compared to \$8.3 million for the same period in 2009. This increase is primarily attributable to a reduction in interest expense due to a decrease in the cost of funds for time deposits.

Interest income decreased \$408,000 or 3% for the three months ended September 30, 2010 compared with the same period in 2009. The decrease was primarily due to a reduction in average loans combined with a decrease in net income associated with derivative instruments. Net income from derivative instruments was \$383,000 for the three

months ended September 30, 2010 when compared to \$614,000 for the same period in 2009. The average yield on earning assets for the quarters ended September 30, 2010 and 2009 was 4.87% and 5.18%, respectively. During the quarter ended September 30, 2010, average loans decreased \$35.9 million to \$788.4 million from \$788.3 million for the three months ended September 30, 2009. During the quarter ended September 30, 2010, average investment securities available-for-sale increased \$62.8 million to \$234.8 million from \$172.0 million for the three months ended September 30, 2009 primarily due to the investment of additional funds received from the growth in deposits and a decrease in loans.

Interest expense decreased \$616,000 or 15% for the three months ended September 30, 2010 compared with the same period in 2009. The average rate paid on interest-bearing checking and savings accounts was 1.08% for the three months ended September 30, 2010 as compared to 1.25% for the same period of 2009. The average rate paid on certificates of deposits was 1.62% for the three months ended September 30, 2010 compared to 2.16% for the same period one year ago.

Net interest income increased to \$24.8million for the nine months ended September 30, 2010 compared to \$24.3 million for the same period in 2009. This increase is primarily attributable to a reduction in interest expense due to a decrease in the cost of funds for time deposits.

Interest income decreased \$1.7 million or 5% for the nine months ended September 30, 2010 compared with the same period in 2009. The decrease was due to a reduction in loan balances and a decrease in income from interest rate derivative contracts, which was partially offset by an increase in interest earning assets. Net income from derivative instruments was \$1.1 million for the nine months ended September 30, 2010 compared to \$2.6 million for the same period one year ago. The average yield on earning assets for the nine months ended September 30, 2010 and 2009 was 4.94% and 5.38%, respectively. During the nine months ended September 30, 2010, average loans decreased \$20.1 million to \$762.7 million from \$782.8 million for the nine months ended September 30, 2009. During the nine months ended September 30, 2010, average investment securities available-for-sale increased \$60.4 million to \$212.0 million from \$151.6 million for the nine months ended September 30, 2009 primarily due to the investment of additional funds received from the growth in deposits and a decrease in loans.

Interest expense decreased \$2.1 million or 16% for the nine months ended September 30, 2010 compared with the same period in 2009. The average rate paid on interest-bearing checking and savings accounts was 1.15% for the nine months ended September 30, 2010 as compared to 1.20% for the same period of 2009. The average rate paid on certificates of deposits was 1.72% for the nine months ended September 30, 2010 compared to 2.48% for the same period one year ago.

Provision for Loan Losses. For the three months ended September 30, 2010 a contribution of \$4.7 million was made to the provision for loan losses compared to a \$3.1 million contribution to the provision for loan losses for the three months ended September 30, 2009. The increase in the provision for loan losses is primarily attributable to a \$20.5 million increase in non-accrual loans during the third quarter of 2010 and a \$3.0 million increase in net charge-offs during the third quarter of 2010 compared to third quarter 2009. The increase in non-accrual loans during third quarter 2010 is partially due to the classification of loans as non-accrual that are current but whose repayment is dependent upon the underlying collateral and whose terms are interest only.

The provision for loan losses for the nine months ended September 30, 2010 was \$10.2 million as compared to \$7.2 million for the same period one year ago. The increase in the provision for loan losses is primarily attributable to an increase in non-performing assets and a \$5.2 million increase in net charge-offs during the nine months ended September 30, 2010 compared to the same period last year. Net charge-offs during the nine months ended September 30, 2010 included \$3.9 million on acquisition, development and construction ("AD&C") loans, \$2.2 million on mortgage loans and \$1.8 million on non-real estate loans, which included \$1.4 million on commercial loans.

Non-Interest Income. Total non-interest income was \$3.9 million for the third quarter of 2010 as compared to \$2.5 million for the same period of 2009. Service charges decreased 5% to \$1.4 million for the three months ended September 30, 2010 when compared to the same period one year ago. Other service charges and fees increased to \$523,000 for the three-month period ended September 30, 2010 as compared to \$472,000 for the same period one year ago. The increase in service charges and fees is primarily attributable to growth in the Bank's deposit base coupled with normal pricing changes. Mortgage banking income decreased to \$125,000 during the three months ended September 30, 2010 from \$129,000 for the same period in 2009. Miscellaneous income decreased to \$167,000 for the three months ended September 30, 2010 as compared to \$383,000 for the same period in 2009 primarily due to a \$301,000 increase in net losses and write-downs on foreclosed properties. Recurring non-interest income amounted to \$2.9 million for the three months ended September 30, 2010, as compared to \$2.9 million for the same period last year. Net non-recurring gains of \$940,000 for the three months ended September 30, 2010 included a \$1.5 million gain on the sale of securities, which was partially offset by \$583,000 net losses and write-downs on foreclosed properties. The gain on sale of securities in third quarter 2010 reflects the repositioning of the Bank's investment

portfolio to recognize a portion of the gains in the investment portfolio. Net non-recurring losses of \$360,000 for the three months ended September 30, 2009 included a \$79,000 write-down on an investment combined with a \$281,000 loss on the disposition of assets.

Total non-interest income was \$9.6 million in the nine months ended September 30, 2010 as compared to \$8.9 million for the same period of 2009. Service charges increased 2% to \$4.2 million for the nine months ended September 30, 2010 when compared to the same period one year ago. Other service charges and fees increased 7% to \$1.7 million for the nine months ended September 30, 2010 when compared to the same period one year ago. The increase in service charges and fees is primarily attributable to growth in the Bank's deposit base coupled with normal pricing changes. Mortgage banking income decreased to \$372,000 during the nine months ended September 30, 2010 from \$633,000 for the same period in 2009 due to a reduction in mortgage loan demand. Miscellaneous income was \$1.4 million for the nine months ended September 30, 2010, a 7% increase from \$1.3 million for the same period in 2009. Recurring non-interest

income increased 3% to \$8.6 million for the nine months ended September 30, 2010, as compared to \$8.4 million for the same period one year ago primarily due to a \$217,000 increase in service charges and fees resulting from growth in the deposit base coupled with normal pricing changes. Net non-recurring gains of \$994,000 for the nine months ended September 30, 2010 included a \$1.7 million gain on sale of securities, which was partially offset by \$697,000 net losses and write-downs on foreclosed properties. Net non-recurring gains of \$552,000 for the nine months ended September 30, 2009 included a \$1.8 million gain on sale of securities, which was partially offset by write-downs of three securities totaling \$723,000. This \$1.1 million net gain on the sale and write-down of securities for the nine months ended September 30, 2009 was partially offset by a \$521,000 loss on the disposition of assets.

**Non-Interest Expense.** Total non-interest expense was \$7.2 million for the third quarter of 2010 as compared to \$7.3 million for the third quarter of 2009. Salary and employee benefits totaled \$3.5 million for the three months ended September 30, 2010, as compared to \$3.6 million for the same period in 2009. The decrease in salary and employee benefits is primarily due to a reduction in 401-K plan expense, incentive expense and supplemental retirement plan expense. Occupancy expense totaled \$1.3 million for the three months ended September 30, 2010 as compared to \$1.4 million for the same period of 2009. Other non-interest expense decreased 2% to \$2.3 million for the three months ended September 30, 2010 as compared to the same period in 2009.

Total non-interest expense decreased 5% to \$21.4 million for the nine months ended September 30, 2010 as compared to \$22.6 million for the corresponding period in 2009. Salary and employee benefits totaled \$10.5 million for the nine months ended September 30, 2010, a decrease of 7% from the same period in 2009. The decrease in salary and employee benefits is primarily due to a reduction in commission expense, 401-K plan expense, incentive expense and supplemental retirement plan expense. Occupancy expense totaled \$4.0 million for the nine months ended September 30, 2010 and September 30, 2009. Other non-interest expense decreased 6% to \$7.0 million for the nine months ended September 30, 2010 as compared to the same period in 2009. This decrease in other non-interest expense is primarily attributable to a decrease of \$486,000 in debit card expense.

**Income Taxes.** The Company reported an income tax benefit of \$42,000 for the third quarter of 2010. For the three months ended September 30, 2009, the Company reported an income tax benefit of \$9,000.

The Company reported income taxes of \$454,000 and \$1.2 million for the nine months ended September 30, 2010 and 2009, respectively. This represented an effective tax rate of 17% and 35% for the respective periods. The decrease in the effective tax rate in 2010 is primarily due to an increase in tax deductible investment income combined with a decrease in earnings before taxes.

#### Analysis of Financial Condition

**Investment Securities.** Available-for-sale securities amounted to \$227.5 million at September 30, 2010 compared to \$195.1 million at December 31, 2009. This increase reflects the investment of additional funds received from growth in deposits and a decrease in loans. Average investment securities available for sale for the nine months ended September 30, 2010 amounted to \$234.8 million compared to \$161.1 million for the year ended December 31, 2009.

**Loans.** At September 30, 2010, loans amounted to \$743.3 million compared to \$778.1 million at December 31, 2009, a decrease of \$34.8 million. This decrease reflects a decline in loan originations combined with continuing payments on existing loans. Loans originated or renewed during the nine months ended September 30, 2010 amounting to approximately \$66.1 million were offset by paydowns and payoffs of existing loans. Average loans represented 75% and 82% of average earning assets for the three months ended September 30, 2010 and the year ended December 31, 2009, respectively. The Company had \$2.1 million and \$2.8 million in mortgage loans held for sale as of September 30, 2010 and December 31, 2009, respectively.

Although the Company has a diversified loan portfolio, a substantial portion of the loan portfolio is collateralized by real estate, which is dependent upon the real estate market. Real estate mortgage loans include both commercial and residential mortgage loans. At September 30, 2010, the Company had \$118.9 million in residential mortgage loans, \$100.2 million in home equity loans and \$287.8 million in commercial mortgage loans, which include \$220.3 million using commercial property as collateral and \$67.5 million using residential property as collateral. Residential mortgage loans include \$63.3 million made to customers in the Company's traditional banking offices and \$55.6 million in mortgage loans originated in the Company's Latino banking operations. All residential mortgage loans are originated as fully amortizing loans, with no negative amortization.

At September 30, 2010, the Company had \$140.1 million in AD&C loans. The following table presents a breakout of these loans.

(Dollars in thousands)

|   | Number of<br>Loans | Balance<br>Outstanding | Non-accrual<br>Balance |
|---|--------------------|------------------------|------------------------|
| Land acquisition and development - commercial purposes  | 83                 | \$ 27,136              | \$ 3,276               |
| Land acquisition and development - residential purposes | 384                | 90,876                 | 24,433                 |
| 1 to 4 family residential construction                  | 57                 | 18,385                 | 2,507                  |
| Commercial construction                                 | 6                  | 3,697                  | 250                    |
| Total acquisition, development and construction         | 530                | \$ 140,094             | \$ 30,466              |

At September 30, 2010, troubled debt restructured (“TDR”) loans amounted to \$66.2 million, including \$11.6 million in performing TDR loans. The terms of these loans have been renegotiated to provide a reduction in principal or interest as a result of the deteriorating financial position of the borrower. At December 31, 2009, TDR loans amounted to \$9.2 million, including \$3.8 million in performing TDR loans. The increase in TDR loans at September 30, 2010 compared to December 31, 2009 is primarily due to the classification of all non-accrual loans as TDR as of September 30, 2010.

Allowance for Loan Losses. The allowance for loan losses reflects management's assessment and estimate of the risks associated with extending credit and its evaluation of the quality of the loan portfolio. The Bank periodically analyzes the loan portfolio in an effort to review asset quality and to establish an allowance for loan losses that management believes will be adequate in light of anticipated risks and loan losses. In assessing the adequacy of the allowance, size, quality and risk of loans in the portfolio are reviewed. Other factors considered are:

- the Bank's loan loss experience;
- the amount of past due and non-performing loans;
  - specific known risks;
- the status and amount of other past due and non-performing assets;
  - underlying estimated values of collateral securing loans;
  - current and anticipated economic conditions; and
- other factors which management believes affect the allowance for potential credit losses.

Management uses several measures to assess and monitor the credit risks in the loan portfolio, including a loan grading system that begins upon loan origination and continues until the loan is collected or collectibility becomes doubtful. Upon loan origination, the Bank's originating loan officer evaluates the quality of the loan and assigns one of nine risk grades. The loan officer monitors the loan's performance and credit quality and makes changes to the credit grade as conditions warrant. When originated or renewed, all loans over a certain dollar amount receive in-depth reviews and risk assessments by the Bank's Credit Administration. Before making any changes in these risk grades, management considers assessments as determined by the third party credit review firm (as described below), regulatory examiners and the Bank's Credit Administration. Any issues regarding the risk assessments are addressed by the Bank's senior credit administrators and factored into management's decision to originate or renew the loan. The Bank's Board of Directors reviews, on a monthly basis, an analysis of the Bank's reserves relative to the range of reserves estimated by the Bank's Credit Administration.

As an additional measure, the Bank engages an independent third party to review the underwriting, documentation and risk grading analyses. This independent third party reviews and evaluates all loan relationships greater than \$1.0 million. The third party's evaluation and report is shared with management and the Bank's Board of Directors.

Management considers certain commercial loans with weak credit risk grades to be individually impaired and measures such impairment based upon available cash flows and the value of the collateral. Allowance or reserve levels



are estimated for all other graded loans in the portfolio based on their assigned credit risk grade, type of loan and other matters related to credit risk.

Management uses the information developed from the procedures described above in evaluating and grading the loan portfolio. This continual grading process is used to monitor the credit quality of the loan portfolio and to assist management in estimating the allowance for loan losses.

The allowance for loan losses is comprised of three components: specific reserves, general reserves and unallocated reserves. After a loan has been identified as impaired, management measures impairment. When the measure of the impaired loan is less than the recorded investment in the loan, the amount of the impairment is recorded as a specific reserve. These specific reserves are determined on an individual loan basis based on management's current evaluation of the Company's loss exposure for each credit, given the appraised value of any underlying collateral. Loans for which

specific reserves are provided are excluded from the general allowance calculations as described below. At September 30, 2010 and December 31, 2009, the recorded investment in loans that were considered to be impaired was approximately \$41.1 million and \$16.6 million, respectively, with related allowance for loan losses of approximately \$2.4 million and \$673,000, respectively.

The general allowance reflects reserves established for collective loan impairment. These reserves are based upon historical net charge-offs using the last two years' experience. This charge-off experience may be adjusted to reflect the effects of current conditions. The Bank considers information derived from its loan risk ratings and external data related to industry and general economic trends.

The unallocated allowance is determined through management's assessment of probable losses that are in the portfolio but are not adequately captured by the other two components of the allowance, including consideration of current economic and business conditions and regulatory requirements. The unallocated allowance also reflects management's acknowledgement of the imprecision and subjectivity that underlie the modeling of credit risk. Due to the subjectivity involved in determining the overall allowance, including the unallocated portion, this unallocated portion may fluctuate from period to period based on management's evaluation of the factors affecting the assumptions used in calculating the allowance.

Management considers the allowance for loan losses adequate to cover the estimated losses inherent in the Company's loan portfolio as of the date of the financial statements. Management believes it has established the allowance in accordance with GAAP and in consideration of the current economic environment. Although management uses the best information available to make evaluations, significant future additions to the allowance may be necessary based on changes in economic and other conditions, thus adversely affecting the operating results of the Company.

There were no significant changes in the estimation methods or fundamental assumptions used in the evaluation of the allowance for loan losses for the nine months ended September 30, 2010 as compared to the year ended December 31, 2009. Such revisions, estimates and assumptions are made in any period in which the supporting factors indicate that loss levels may vary from the previous estimates.

Additionally, various regulatory agencies, as an integral part of their examination process, periodically review the Bank's allowance for loan losses. Such agencies may require adjustments to the allowance based on their judgments of information available to them at the time of their examinations.

The allowance for loan losses at September 30, 2010 amounted to \$17.7 million or 2.38% of total loans compared to \$15.4 million or 1.98% of total loans at December 31, 2009. The Bank believes it has established the allowance for credit losses pursuant to generally accepted accounting principles, and has taken into account the views of its regulators and the current economic environment.

The following table presents the percentage of loans assigned to each risk grade at September 30, 2010 and December 31, 2009.

#### LOAN RISK GRADE ANALYSIS:

| Risk Grade                          | Percentage of Loans<br>By Risk Grade* |            |
|-------------------------------------|---------------------------------------|------------|
|                                     | 09/30/2010                            | 12/31/2009 |
| Risk Grade 1 (Excellent Quality)    | 3.42%                                 | 3.52%      |
| Risk Grade 2 (High Quality)         | 16.79%                                | 16.34%     |
| Risk Grade 3 (Good Quality)         | 47.22%                                | 51.12%     |
| Risk Grade 4 (Management Attention) | 18.34%                                | 17.16%     |

|                                |       |       |
|--------------------------------|-------|-------|
| Risk Grade 5 (Watch)           | 5.43% | 7.43% |
| Risk Grade 6 (Substandard)     | 1.60% | 1.45% |
| Risk Grade 7 (Low Substandard) | 0.00% | 0.04% |
| Risk Grade 8 (Doubtful)        | 0.00% | 0.00% |
| Risk Grade 9 (Loss)            | 0.00% | 0.00% |

\* Excludes non-accrual loans

At September 30, 2010 there were seven relationships exceeding \$1.0 million (which totaled \$11.8 million) in the Watch risk grade, ten relationships exceeding \$1.0 million in the Substandard risk grade (which totaled \$19.4 million) and no relationships exceeding \$1.0 million in the Low Substandard risk grade. There was one relationship in the Watch risk grade and the Substandard risk grade totaling \$1.5 million. These customers continue to meet payment requirements in accordance with the terms of the promissory notes on these loans.

**Non-performing Assets.** Non-performing assets totaled \$57.3 million at September 30, 2010 or 5.30% of total assets, compared to \$28.8 million at December 31, 2009, or 2.75% of total assets. Non-accrual loans were \$52.4 million at September 30, 2010 and \$22.8 million at December 31, 2009. As a percentage of total loans outstanding, non-accrual loans were 7.05% at September 30, 2010 compared to 2.93% at December 31, 2009. Non-performing loans include \$30.5 million in AD&C loans, \$19.8 million in commercial and residential mortgage loans and \$2.3 million in other loans at September 30, 2010 as compared to \$4.8 million in AD&C loans, \$18.3 million in commercial and residential mortgage loans and \$1.7 million in other loans as of December 31, 2009. Included in AD&C non-accrual loans at September 30, 2010 is \$14.0 million in loans to the largest AD&C relationship in the Bank. The Bank had loans 90 days past due and still accruing totaling \$96,000 and \$2.0 million as of September 30, 2010 and December 31, 2009, respectively. Other Real Estate Owned totaled \$4.8 million as of September 30, 2010 as compared to \$4.0 million at December 31, 2009. The Bank had no repossessed assets as of September 30, 2010 and December 31, 2009. The increase in non-accrual loans during third quarter 2010 is partially due to the classification of loans as non-accrual that are current but whose repayment is dependent upon the underlying collateral and whose terms are interest only.

**Deposits.** Total deposits at September 30, 2010 were \$842.3 million, an increase of \$33.0 million over deposits of \$809.3 million at December 31, 2009. Core deposits, which include non-interest bearing demand deposits, NOW, MMDA, savings and non-brokered certificates of deposits of denominations less than \$100,000, increased \$18.6 million to \$587.6 million at September 30, 2010 as compared to \$569.0 million at December 31, 2009. The Bank offers remote deposit capture for customers which has enabled the Bank to gather additional deposits from several existing customers and has been helpful in attracting new customers. Certificates of deposit in amounts greater than \$100,000 or more totaled \$249.2 million at September 30, 2010 as compared to \$233.1 million at December 31, 2009. This increase is partially due to a \$8.2 million increase in certificates of deposit issued through the Certificate of Deposit Account Registry Service (CDARS) as of September 30, 2010 compared to December 31, 2009. At September 30, 2010, brokered deposits amounted to \$92.8 million as compared to \$84.0 million at December 31, 2009. Brokered deposits outstanding as of September 30, 2010 had a weighted average rate of 1.24% with a weighted average original term of 13 months as compared to brokered deposits outstanding at December 31, 2009 which had a weighted average rate of 1.90% with a weighted average original term of 14 months.

**Borrowed Funds.** Borrowings from the FHLB totaled \$70.0 million and \$77.0 million at September 30, 2010 and December 31, 2009, respectively. The average balance of FHLB borrowings for the nine months ended September 30, 2010 was \$72.7 million compared to \$77.3 million for the year ended December 31, 2009. At September 30, 2010, all of the Bank's FHLB borrowings had maturities exceeding one year. The FHLB has the option to convert \$60.0 million of the total advances to a floating rate and, if converted, the Bank may repay advances without a prepayment fee. The Company also has an additional \$5.0 million in an advance that has been converted to a fixed rate by the FHLB, which may be repaid with a prepayment fee.

The Bank had no borrowings from the Federal Reserve Bank ("FRB") at September 30, 2010 and December 31, 2009.

The Company had no federal funds purchased as of September 30, 2010 or December 31, 2009.

Securities sold under agreements to repurchase were \$41.5 million at September 30, 2010 compared to \$36.9 million at December 31, 2009.

**Junior Subordinated Debentures (related to Trust Preferred Securities).** In June 2006 the Company formed a wholly owned Delaware statutory trust, PEBK Capital Trust II ("PEBK Trust II"), which issued \$20.0 million of guaranteed preferred beneficial interests in the Company's junior subordinated deferrable interest debentures. All of the common securities of PEBK Trust II are owned by the Company. The proceeds from the issuance of the common securities and the trust preferred securities were used by PEBK Trust II to purchase \$20.6 million of junior subordinated debentures of the Company, which pay a floating rate equal to three-month LIBOR plus 163 basis points. The

proceeds received by the Company from the sale of the junior subordinated debentures were used to repay in December 2006 the trust preferred securities issued by PEBK Capital Trust I in December 2001 and for general purposes. The debentures represent the sole asset of PEBK Trust II. PEBK Trust II is not included in the consolidated financial statements.

The trust preferred securities issued by PEBK Trust II accrue and pay quarterly at a floating rate of three-month LIBOR plus 163 basis points. The Company has guaranteed distributions and other payments due on the trust preferred securities to the extent PEBK Trust II has funds with which to make the distributions and other payments. The net combined effect of the trust preferred securities transaction is that the Company is obligated to make the distributions and other payments required on the trust preferred securities.

These trust preferred securities are mandatorily redeemable upon maturity of the debentures on June 28, 2036, or upon earlier redemption as provided in the indenture. The Company has the right to redeem the debentures purchased by PEBK Trust II, in whole or in part, on or after June 28, 2011. As specified in the indenture, if the debentures are redeemed prior to maturity, the redemption price will be the principal amount and any accrued but unpaid interest.

**Asset Liability and Interest Rate Risk Management.** The objective of the Company's Asset Liability and Interest Rate Risk strategies is to identify and manage the sensitivity of net interest income to changing interest rates and to minimize the interest rate risk between interest-earning assets and interest-bearing liabilities at various maturities. This is to be done in conjunction with the need to maintain adequate liquidity and the overall goal of maximizing net interest income.

The Company manages its exposure to fluctuations in interest rates through policies established by the Asset/Liability Committee ("ALCO") of the Bank. The ALCO meets monthly and has the responsibility for approving asset/liability management policies, formulating and implementing strategies to improve balance sheet positioning and/or earnings and reviewing the interest rate sensitivity of the Company. ALCO tries to minimize interest rate risk between interest-earning assets and interest-bearing liabilities by attempting to minimize wide fluctuations in net interest income due to interest rate movements. The ability to control these fluctuations has a direct impact on the profitability of the Company. Management monitors this activity on a regular basis through analysis of its portfolios to determine the difference between rate sensitive assets and rate sensitive liabilities.

The Company's rate sensitive assets are those earning interest at variable rates and those with contractual maturities within one year. Rate sensitive assets therefore include both loans and available-for-sale securities. Rate sensitive liabilities include interest-bearing checking accounts, money market deposit accounts, savings accounts, time deposits and borrowed funds. The Company's balance sheet is asset-sensitive, meaning that in a given period there will be more assets than liabilities subject to immediate repricing as interest rates change in the market. Because the majority of the Company's loans are tied to the prime rate, they reprice more rapidly than rate sensitive interest-bearing deposits. During periods of rising rates, this results in increased net interest income. The opposite occurs during periods of declining rates. Average rate sensitive assets for the nine months ended September 30, 2010 totaled \$992.4 million, exceeding average rate sensitive liabilities of \$848.3 million by \$144.1 million.

The Company has an overall interest rate risk management strategy that incorporates the use of derivative instruments to minimize significant unplanned fluctuations in earnings that are caused by interest rate volatility. By using derivative instruments, the Company is exposed to credit and market risk. If the counterparty fails to perform, credit risk is equal to the extent of the fair-value gain in the derivative. The Company minimizes the credit risk in derivative instruments by entering into transactions with high-quality counterparties that are reviewed periodically by the Company. As of September 30, 2010, the Company had one interest rate swap with a notional amount of \$50.0 million that was designated as a cash flow hedge of interest rate risk. The interest rate swap contract is used to convert \$50.0 million of variable rate loans to a fixed rate. Under the swap contract, the Company receives a fixed rate of 6.245% and pays a variable rate based on the current prime rate (3.25% at September 30, 2010) on the notional amount of \$50.0 million. The swap agreement matures in June 2011. The Company recognized \$1.1 million in interest income from interest rate derivative contracts during the nine months ended September 30, 2010. Based on the current interest rate environment, it is expected the Company will continue to receive income on this interest rate contract throughout 2010. The effective portion of changes in the fair value of derivatives designated and that qualify as cash flow hedges is recorded in Accumulated Other Comprehensive Income and is subsequently reclassified into earnings in the period that the hedged forecasted transaction affects earnings. During 2010, such derivatives were used to hedge the variable cash inflows associated with existing pools of prime-based loan assets. The ineffective portion of the change in fair value of the derivatives is recognized directly in earnings.

DERIVATIVE INSTRUMENTS AS OF SEPTEMBER 30, 2010

(Dollars in thousands)

| Type of Derivative                           |    | Notional<br>Amount | Contract<br>Rate | Year-to-date<br>Income |
|--|----|--------------------|------------------|------------------------|
| Interest rate swap contact expiring 06/01/11 | \$ | 50,000             | 6.245%           | \$ 1,136               |

Included in the rate sensitive assets are \$444.7 million in variable rate loans indexed to prime rate subject to immediate repricing upon changes by the Federal Open Market Committee ("FOMC"). The Bank utilizes interest rate floors on certain variable rate loans to protect against further downward movements in the prime rate. At September 30, 2010, the Bank had \$330.4 million in loans with interest rate floors. The floors were in effect on \$328.3 million of these loans pursuant to the terms of the promissory notes on these loans. The weighted average rate on these loans is 1.14% higher than the indexed rate on the promissory notes without interest rate floors.

**Liquidity.** The objectives of the Company's liquidity policy are to provide for the availability of adequate funds to meet the needs of loan demand, deposit withdrawals, maturing liabilities and to satisfy regulatory requirements. Both deposit and loan customer cash needs can fluctuate significantly depending upon business cycles, economic conditions and yields and returns available from alternative investment opportunities. In addition, the Company's liquidity is affected by off-balance sheet commitments to lend in the form of unfunded commitments to extend credit and standby letters of credit. As of September 30, 2010 such unfunded commitments to extend credit were \$140.0 million, while commitments in the form of standby letters of credit totaled \$3.9 million.

The Company uses several sources to meet its liquidity requirements. The primary source is core deposits, which includes demand deposits, savings accounts and non-brokered certificates of deposits of denominations less than \$100,000. The Company considers these to be a stable portion of the Company's liability mix and the result of on-going consumer and commercial banking relationships. As of September 30, 2010, the Company's core deposits totaled \$587.6 million, or 70% of total deposits.

The other sources of funding for the Company are through large denomination certificates of deposit, including brokered deposits, federal funds purchased, securities under agreement to repurchase and FHLB borrowings. The Bank is also able to borrow from the FRB on a short-term basis. The Bank's policies include the ability to access wholesale funding up to 40% of total assets. The Bank's wholesale funding includes FHLB borrowings, FRB borrowings, brokered deposits, internet certificates of deposit and certificates of deposit issued to the State of North Carolina. The Company's ratio of wholesale funding to total assets was 15.40% as of September 30, 2010.

At September 30, 2010, the Bank had a significant amount of deposits in amounts greater than \$100,000, including brokered deposits of \$92.8 million, which have an average maturity of 13 months. The cost of these deposits is more susceptible to changes in the interest rate environment than other deposits. Access to the brokered deposit market could be restricted if the Bank were to fall below the well capitalized level.

The Bank has a line of credit with the FHLB equal to 20% of the Bank's total assets, with an outstanding balance of \$70.0 million at September 30, 2010. The remaining availability at the FHLB was \$4.3 million at September 30, 2010. At September 30, 2010, the carrying value of loans pledged as collateral to the FHLB totaled approximately \$141.4 million. The Bank had no borrowings from the FRB at September 30, 2010. FRB borrowings are collateralized by a blanket assignment on all qualifying loans that the Bank owns which are not pledged to the FHLB. At September 30, 2010, the carrying value of loans pledged as collateral to the FRB totaled approximately \$375.6 million. In third quarter 2009, the Bank increased its overall borrowing capacity by pledging commercial real estate loans to the FRB that were previously pledged to the FHLB.

The Bank also had the ability to borrow up to \$55.5 million for the purchase of overnight federal funds from five correspondent financial institutions as of September 30, 2010.

The liquidity ratio for the Bank, which is defined as net cash, interest bearing deposits with banks, federal funds sold and certain investment securities, as a percentage of net deposits and short-term liabilities was 26.92% at September 30, 2010 and 19.10% at December 31, 2009. The minimum required liquidity ratio as defined in the Bank's Asset/Liability and Interest Rate Risk Management Policy is 10%.

**Contractual Obligations and Off-Balance Sheet Arrangements.** The Company's contractual obligations and other commitments as of September 30, 2010 and December 31, 2009 are summarized in the table below. The Company's contractual obligations include the repayment of principal and interest related to FHLB advances and junior subordinated debentures, as well as certain payments under current lease agreements. Other commitments include commitments to extend credit. Because not all of these commitments to extend credit will be drawn upon, the actual cash requirements are likely to be significantly less than the amounts reported for other commitments below.



(Dollars in thousands)

|  | September 30, 2010 | December 31,<br>2009 |
|--|--------------------|----------------------|
| <b>Contractual Cash Obligations</b>                        |                    |                      |
| Long-term borrowings                                       | \$ 70,000          | 77,000               |
| Junior subordinated debentures                             | 20,619             | 20,619               |
| Operating lease obligations                                | 3,372              | 3,859                |
| <b>Total</b>   | <b>\$ 93,991</b>   | <b>101,478</b>       |
| <b>Other Commitments</b>                                   |                    |                      |
| Commitments to extend credit                               | \$ 140,035         | 140,207              |
| Standby letters of credit and financial guarantees written | 3,852              | 3,302                |
| <b>Total</b>   | <b>\$ 143,887</b>  | <b>143,509</b>       |

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The Company enters into derivative contracts to manage various financial risks. A derivative is a financial instrument that derives its cash flows, and therefore its value, by reference to an underlying instrument, index or referenced interest rate. Derivative contracts are carried at fair value on the consolidated balance sheet with the fair value representing the net present value of expected future cash receipts or payments based on market interest rates as of the balance sheet date. Derivative contracts are written in amounts referred to as notional amounts, which only provide the basis for calculating payments between counterparties and are not a measure of financial risk. Further discussions of derivative instruments are included above in the section entitled "Asset Liability and Interest Rate Risk Management".

Capital Resources. Shareholders' equity at September 30, 2010 was \$102.4 million compared to \$99.2 million at December 31, 2009. At September 30, 2010 and December 31, 2009, accumulated comprehensive income amounted to \$5.0 million and \$2.9 million, respectively. Annualized return on average equity for the three months ended September 30, 2010 was 2.09% compared to 2.88% for the year ended December 31, 2009. Total cash dividends paid on common stock during the nine months ended September 30, 2010 amounted to \$332,000 as compared to total cash dividends of \$1.3 million paid for the nine months ended September 30, 2009.

The Board of Directors, at its discretion, can issue shares of preferred stock up to a maximum of 5,000,000 shares. The Board is authorized to determine the number of shares, voting powers, designations, preferences, limitations and relative rights.

On December 23, 2008, the Company entered into a Purchase Agreement with the UST. Under the Purchase Agreement, the Company agreed to issue and sell 25,054 shares of Series A preferred stock and a warrant to purchase 357,234 shares of common stock associated with the Company's participation in the CPP under the TARP. Proceeds from this issuance of preferred shares were allocated between preferred stock and the warrant based on their relative fair values at the time of the sale. Of the \$25.1 million in proceeds, \$24.4 million was allocated to the Series A preferred stock and \$704,000 was allocated to the common stock warrant. Additional discussion of the Company's participation in the CPP can be found on page 18. The Board of Directors does not currently anticipate issuing any additional series of preferred stock.

Under the regulatory capital guidelines, financial institutions are currently required to maintain a total risk-based capital ratio of 8.0% or greater, with a Tier 1 risk-based capital ratio of 4.0% or greater. Tier 1 capital is generally defined as shareholders' equity and trust preferred securities less all intangible assets and goodwill. Tier 1 capital at September 30, 2010 and December 31, 2009 includes \$20.0 million in trust preferred securities. The Company's Tier 1 capital ratio was 14.30% and 13.74% at September 30, 2010 and December 31, 2009, respectively. Total risk-based capital is defined as Tier 1 capital plus supplementary capital. Supplementary capital, or Tier 2 capital, consists of the Company's allowance for loan losses, not exceeding 1.25% of the Company's risk-weighted assets. Total risk-based capital ratio is therefore defined as the ratio of total capital (Tier 1 capital and Tier 2 capital) to risk-weighted assets. The Company's total risk-based capital ratio was 15.56% and 15.00% at September 30, 2010 and December 31, 2009, respectively. In addition to the Tier 1 and total risk-based capital requirements, financial institutions are also required to maintain a leverage ratio of Tier 1 capital to total average assets of 4.0% or greater. The Company's Tier 1 leverage capital ratio was 10.86% and 11.42% at September 30, 2010 and December 31, 2009, respectively.

The Bank's Tier 1 risk-based capital ratio was 11.86% and 11.22% at September 30, 2010 and December 31, 2009, respectively. The total risk-based capital ratio for the Bank was 13.14% and 12.48% at September 30, 2010 and December 31, 2009, respectively. The Bank's Tier 1 leverage capital ratio was 9.00% and 9.33% at September 30, 2010 and December 31, 2009, respectively.

A bank is considered to be "well capitalized" if it has a total risk-based capital ratio of 10.0 % or greater, a Tier 1 risk-based capital ratio of 6.0% or greater, and has a leverage ratio of 5.0% or greater. Based upon these guidelines,

the Bank was considered to be "well capitalized" at September 30, 2010.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Not required for smaller reporting companies.

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Item 4T. Controls and Procedures

The Company's management, with the participation of the Company's Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the Company's disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) as of the end of the period covered by this report. Based on such evaluation, the Company's Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of such period, the Company's disclosure controls and procedures are effective in recording, processing, summarizing and reporting, on a timely basis, information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act.

There have not been any changes in the Company's internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the fiscal quarter to which this report relates that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

## PART OTHER INFORMATION

## II.

## Item 1. Legal Proceedings

In the opinion of management, the Company is not involved in any material pending legal proceedings other than routine proceedings occurring in the ordinary course of business.

## Item Risk Factors

## 1A.

Not required for smaller reporting companies.

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

## ISSUER PURCHASES OF EQUITY SECURITIES

|                        | Total<br>Number<br>of<br>Shares<br>Purchased | Average<br>Price Paid<br>per Share | Total<br>Number of<br>Shares<br>Purchased<br>as<br>Part of<br>Publicly<br>Announced<br>Plans or<br>Programs | Maximum<br>Number of<br>Shares that<br>May Yet Be<br>Purchased<br>Under the<br>Plans<br>or<br>Programs |
|------------------------|--|------------------------------------|---|--|
| July 1 - 31, 2010      | 2,590  | \$ 5.01                            | -   | -  |
| August 1 - 31, 2010    | -  | -                                  | -   | -  |
| September 1 - 30, 2010 | 5,285  | 5.11                               | -   | -  |
| Total                  | 7,875 (1)                                    | \$ 5.08                            | -   | -  |

(1) The Company purchased 7,875 shares on the open market in 2010 for its deferred compensation plan. All purchases were funded by participant contributions to the plan. The agreements with UST under the CPP program allow the Company to purchase its common stock pursuant to benefit plans in place prior to participation in the CPP.

## Item 3. Defaults Upon Senior Securities

Not applicable

Item 5. Other Information

Not applicable

Item 6. Exhibits

- Exhibit (3)(1) Articles of Amendment dated December 19, 2008, regarding the Series A Preferred Stock, incorporated by reference to Exhibit (3)(1) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008
- Exhibit (3)(2) Articles of Amendment dated February 26, 2010, incorporated by reference to Exhibit (3)(2) to the Form 10-K filed with the Securities and Exchange Commission on March 25, 2010
- Exhibit (3)(i) Articles of Incorporation of Peoples Bancorp of North Carolina, Inc., incorporated by reference to Exhibit (3)(i) to the Form 8-A filed with the Securities and Exchange Commission on September 2, 1999

- Exhibit (3)(ii) Amended and Restated Bylaws of Peoples Bancorp of North Carolina, Inc., incorporated by reference to Exhibit (3)(ii) to the Form 10-K filed with the Securities and Exchange Commission on March 25, 2010
- Exhibit (4) Specimen Stock Certificate, incorporated by reference to Exhibit (4) to the Form 8-A filed with the Securities and Exchange Commission on September 2, 1999
- Exhibit (4)(1) Form of Certificate for the Series A Preferred Stock, incorporated by reference to Exhibit (4)(1) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008
- Exhibit (4)(2) Warrant dated December 23, 2008, for the purchase of shares of Common Stock, incorporated by reference to Exhibit (4)(2) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008
- Exhibit (10)(1) Letter Agreement dated December 23, 2008 between the Registrant and the United States Department of the Treasury, incorporated by reference to Exhibit (10)(1) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008
- Exhibit (10)(a)(i) Employment Letter Agreement dated December 23, 2008 between Peoples Bancorp of North Carolina, Inc. and Tony W. Wolfe, incorporated by reference to Exhibit (10)(a)(i) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008
- Exhibit (10)(a)(ii) Amendment to Employment Agreement between Peoples Bank and Tony W. Wolfe dated December 18, 2008, incorporated by reference to Exhibit (10)(a)(ii) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008
- Exhibit (10)(a)(iii) Amended and Restated Executive Salary Continuation Agreement between Peoples Bank and Tony W. Wolfe dated December 18, 2008, incorporated by reference to Exhibit (10)(a)(iii) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008
- Exhibit (10)(b)(i) Employment Letter Agreement dated December 23, 2008 between Peoples Bancorp of North Carolina, Inc. and Joseph F. Beaman, Jr., incorporated by reference to Exhibit (10)(b)(i) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008



- Exhibit (10)(b)(ii)      Amendment to Employment Agreement between Peoples Bank and Joseph F. Beaman, Jr. dated December 18, 2008, incorporated by reference to Exhibit (10)(b)(ii) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008
- Exhibit (10)(b)(iii)      Amended and Restated Executive Salary Continuation Agreement between Peoples Bank and Joseph F. Beaman, Jr. dated December 18, 2008, incorporated by reference to Exhibit (10)(b)(iii) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008
- Exhibit (10)(c)(i)      Employment Letter Agreement dated December 23, 2008 between Peoples Bancorp of North Carolina, Inc. and William D. Cable, Sr., incorporated by reference to Exhibit (10)(c)(i) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008
- Exhibit (10)(c)(ii)      Amendment to Employment Agreement between Peoples Bank and William D. Cable, Sr. dated December 18, 2008, incorporated by reference to Exhibit (10)(c)(ii) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008

- Exhibit (10)(c)(iii) Amended and Restated Executive Salary Continuation Agreement between Peoples Bank and William D. Cable, Sr. dated December 18, 2008, incorporated by reference to Exhibit (10)(c)(iii) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008
- Exhibit (10)(d)(i) Employment Letter Agreement dated December 23, 2008 between Peoples Bancorp of North Carolina, Inc. and Lance A. Sellers, incorporated by reference to Exhibit (10)(d)(i) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008
- Exhibit (10)(d)(ii) Amendment to Employment Agreement between Peoples Bank and Lance A. Sellers dated December 18, 2008, incorporated by reference to Exhibit (10)(d)(ii) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008
- Exhibit (10)(d)(iii) Amended and Restated Executive Salary Continuation Agreement between Peoples Bank and Lance A. Sellers dated December 18, 2008, incorporated by reference to Exhibit (10)(d)(iii) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008
- Exhibit (10)(e) Peoples Bancorp of North Carolina, Inc. Omnibus Stock Ownership and Long Term Incentive Plan incorporated by reference to Exhibit (10)(f) to the Form 10-K filed with the Securities and Exchange Commission on March 30, 2000
- Exhibit (10)(e)(i) Amendment No. 1 to the Peoples Bancorp of North Carolina, Inc. Omnibus Stock Ownership and Long Term Incentive Plan incorporated by reference to Exhibit (10)(e)(i) to the Form 10-K filed with the Securities and Exchange Commission on March 15, 2007
- Exhibit (10)(f)(i) Employment Letter Agreement dated December 23, 2008 between Peoples Bancorp of North Carolina, Inc. and A. Joseph Lampron, incorporated by reference to Exhibit (10)(f)(i) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008
- Exhibit (10)(f)(ii) Amendment to Employment Agreement between Peoples Bank and A. Joseph

Lampron dated March 18, 2010, incorporated by reference to Exhibit (10)(f)(ii) to the Form 10-K filed with the Securities and Exchange Commission on March 25, 2010

Exhibit (10)(f)(iii) Amended and Restated Executive Salary Continuation Agreement between Peoples Bank and A. Joseph Lampron dated December 18, 2008, incorporated by reference to Exhibit (10)(f)(iii) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008

Exhibit (10)(g) Peoples Bank Directors' and Officers' Deferral Plan, incorporated by reference to Exhibit (10)(h) to the Form 10-K filed with the Securities and Exchange Commission on March 28, 2002

Exhibit (10)(h) Rabbi Trust for the Peoples Bank Directors' and Officers' Deferral Plan, incorporated by reference to Exhibit (10)(i) to the Form 10-K filed with the Securities and Exchange Commission on March 28, 2002

Exhibit (10)(i) Description of Service Recognition Program maintained by Peoples Bank, incorporated by reference to Exhibit (10)(i) to the Form 10-K filed with the Securities and Exchange Commission on March 27, 2003

Exhibit (10)(j) Capital Securities Purchase Agreement dated as of June 26, 2006, by and among Peoples Bancorp of North Carolina, Inc., PEBK Capital Trust II and Bear, Sterns Securities Corp., incorporated by reference to Exhibit (10)(j) to the Form 10-Q filed with the Securities and Exchange Commission on November 13, 2006

- Exhibit (10)(k) Amended and Restated Trust Agreement of PEBK Capital Trust II, dated as of June 28, 2006 incorporated by reference to Exhibit (10)(k) to the Form 10-Q filed with the Securities and Exchange Commission on November 13, 2006
- Exhibit (10)(l) Guarantee Agreement of Peoples Bancorp of North Carolina, Inc. dated as of June 28, 2006 incorporated by reference to Exhibit (10)(l) to the Form 10-Q filed with the Securities and Exchange Commission on November 13, 2006
- Exhibit (10)(m) Indenture, dated as of June 28, 2006, by and between Peoples Bancorp of North Carolina, Inc. and LaSalle Bank National Association, as Trustee, relating to Junior Subordinated Debt Securities Due September 15, 2036, incorporated by reference to Exhibit (10)(m) to the Form 10-Q filed with the Securities and Exchange Commission on November 13, 2006
- Exhibit (10)(n) Form of Amended and Restated Director Supplemental Retirement Agreement between Peoples Bank and Directors Robert C. Abernethy, James S. Abernethy, Douglas S. Howard, John W. Lineberger, Jr., Gary E. Matthews, Dr. Billy L. Price, Jr., Larry E. Robinson, W. Gregory Terry, Dan Ray Timmerman, Sr. and Benjamin I. Zachary, incorporated by reference to Exhibit (10)(n) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008
- Exhibit (10)(o) 2009 Peoples Bancorp of North Carolina, Inc. Omnibus Stock Ownership and Long Term Incentive Plan incorporated by reference to Exhibit (10)(o) to the Form 10-K filed with the Securities and Exchange Commission on March 20, 2009
- Exhibit (14) Code of Business Conduct and Ethics of Peoples Bancorp of North Carolina, Inc., incorporated by reference to Exhibit (14) to the Form 10-K filed with the Securities and Exchange Commission on March 25, 2005
- Exhibit (31)(a) Certification of principal executive officer pursuant to section 302 of the Sarbanes-Oxley Act of 2002
- Exhibit (31)(b) Certification of principal financial officer pursuant to section 302 of the Sarbanes-Oxley Act of 2002
- Exhibit (32) Certification Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002



SIGNATURES

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

Peoples Bancorp of North Carolina, Inc.

November  
10, 2010  
Date

/s/ Tony W. Wolfe

Tony W. Wolfe  
President and Chief Executive Officer  
(Principal Executive Officer)

November  
10, 2010  
Date

/s/ A. Joseph Lampron

A. Joseph Lampron  
Executive Vice President and Chief Financial  
Officer  
(Principal Financial and Principal Accounting  
Officer)

