PREMIER BANCORP INC /PA/
Form 10-Q
November 13, 2002

U. S. SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED: SEPTEMBER 30, 2002

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

FOR THE TRANSITION PERIOD FROM ________ TO ________

COMMISSION FILE NUMBER: 1-15513

PREMIER BANCORP, INC.

(Exact name of Registrant as specified in its charter)

| PENNSYLVANIA | 23-2921058 |
|---|---|
| (State or other jurisdiction of incorporation or organization) | (IRS Employer Identification No.) |

379 NORTH MAIN STREET, DOYLESTOWN, PA 18901

(Address of principal executive offices)

(215) 345-5100

(Registrant's telephone number)

N/A

(Former name, former address and former fiscal year, if changed since last report)

Check whether the Registrant (1) filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act 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 [ ]

APPLICABLE ONLY TO CORPORATE ISSUERS

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

Common stock: $0.33 par value; 3,342,415 shares issued and outstanding as of October 31, 2002.

PART I - FINANCIAL INFORMATION

ITEM 1 -- FINANCIAL STATEMENTS

PREMIER BANCORP, INC.
CONSOLIDATED BALANCE SHEETS

| | SEPTE (U |
|---|---|
| | (DOLLA |
| ASSETS: | |
| Cash and due from banks | $ |
| Short-term investments | |
| Interest-bearing deposits | |
| Cash and cash equivalents | |
| Investment securities: | |
| Held to maturity (fair value $500 in 2002 and $500 in 2001) | |
| Available for sale (amortized cost $166,933 in 2002 and $102,399 in 2001) | |
| Loans receivable (net of allowance for loan losses of $4,133 in 2002 and $3,817 in 2001) | |
| Loans held for sale | |
| Other real estate owned | |
| Premises and equipment | |
| Accrued interest receivable | |
| Deferred income taxes | |
| Other assets | |
| Total assets | $ |
| LIABILITIES, MINORITY INTEREST IN SUBSIDIARIES AND SHAREHOLDERS' EQUITY: | |
| Deposits | $ |
| Borrowings | |
| Accrued interest payable | |
| Other liabilities | |
| Subordinated debt | |
| Total liabilities | |
| Corporation-obligated mandatorily redeemable capital securities of subsidiary trusts holding solely junior subordinated debentures of the corporation | |
| SHAREHOLDERS' EQUITY: | |
| Preferred stock- no par value; 20,000,000 shares authorized; Series A Preferred issued and outstanding 552,000 at September 30, 2002 and none at December 31, 2001 | |
| Common stock- $0.33 par value; 30,000,000 shares authorized; issued and outstanding 3,342,415 at September 30, 2002 and 3,242,215 at December 31, 2001 | |
| Additional paid-in capital | |
| Retained earnings | |
| Treasury stock at cost; 109,858 shares at September 30, 2002 and none at December 31, 2001 | |
| Accumulated other comprehensive loss | |
| Total shareholders' equity | |
| Total liabilities, minority interest in subsidiaries and shareholders' equity | $ |

The accompanying notes are an integral part of the consolidated financial statements.



PREMIER BANCORP, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS

| | FOR THE THREE MONTHS ENDED SEPTEMBER 30, 2002 | 2001 | F E 2 |
|---|---|---|---|
| | (UNAUDITED) (DOLLARS IN THOUSANDS, EXCE | | |
| INTEREST INCOME: | | | |
| Loans | $ 6,633 | $ 5,783 | $ |
| Short-term investments and interest-bearing deposits | 194 | 106 | |
| Investments: | | | |
| Taxable | 1,439 | 1,497 | |
| Tax-exempt | 159 | 270 | |
| Total interest income | 8,425 | 7,656 | |
| INTEREST EXPENSE: | | | |
| Deposits | 3,179 | 3,586 | |
| Borrowings | 640 | 611 | |
| Total interest expense | 3,819 | 4,197 | |
| Net interest income | 4,606 | 3,459 | |
| Provision for loan losses | 245 | 179 | |
| Net interest income after loan loss provision | 4,361 | 3,280 | |
| NON-INTEREST INCOME: | | | |
| Service charges and other deposit-related fees | 104 | 84 | |
| Gain, net, on sale of investment securities available for sale | 85 | 3 | |
| Gain (loss) on sale of other real estate owned | - | - | |
| Gain on sale of loans held for sale | 14 | 7 | |
| Other fees | 54 | 44 | |
| Total non-interest income | 257 | 138 | |
| NON-INTEREST EXPENSE: | | | |
| Salaries and employee benefits | 1,358 | 1,099 | |
| Occupancy | 209 | 190 | |
| Data processing | 293 | 233 | |
| Professional services | 56 | 75 | |
| Marketing | 83 | 92 | |
| Minority interest in expense of subsidiaries | 230 | 219 | |
| Other | 546 | 454 | |
| Total non-interest expense | 2,775 | 2,362 | |
| Income before income tax | 1,843 | 1,056 | |
| Income tax expense | 581 | 266 | |
| Net income | $ 1,262 | $ 790 | $ |

| | | | |
|---|---|---|---|
| Less: Preferred stock dividends | $ (149) | $ - | $ |
| Net income applicable to common shareholders | $ 1,113 | $ 790 | $ |
| EARNINGS PER COMMON SHARE: | | | |
| Basic | $ 0.33 | $ 0.24 | $ |
| Diluted | $ 0.32 | $ 0.23 | $ |
| WEIGHTED AVERAGE NUMBER OF COMMON SHARES OUTSTANDING: | | | |
| Basic | 3,401,023 | 3,224,960 | |
| Diluted | 3,524,628 | 3,478,243 | |

The accompanying notes are an integral part of the consolidated financial statements.

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PREMIER BANCORP, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS

| | |
|---|---|
| OPERATING ACTIVITIES: | |
| Net income | $ |
| Adjustments to reconcile net income to cash provided by operating activities: | |
| Depreciation expense | |
| Provision for loan losses | |
| Amortization of premiums and discounts on investment securities available for sale | |
| Gain on sales of investment securities available for sale | |
| (Gain) loss on sales of other real estate owned | |
| Gain on sales of loans held for sale | |
| Originations of loans held for sale | |
| Proceeds from sales of loans held for sale | |
| Increase in accrued interest receivable | |
| Increase in other assets | |
| Increase in deferred loan fees | |
| (Decrease) increase in accrued interest payable | |
| Increase (decrease) in other liabilities | |
| Net cash provided by operating activities | |
| INVESTING ACTIVITIES: | |
| Proceeds from sales of investment securities available for sale | |
| Repayment of investment securities available for sale | |
| Purchases of investment securities available for sale | |
| Repayment of investment securities held to maturity | |
| Net increase in loans receivable | |
| Proceeds from sales of other real estate owned | |
| Purchases of premises and equipment | |

Net cash used in investing activities

FINANCING ACTIVITIES:
Net increase in deposits
Net increase in borrowings less than 90 days
Proceeds from borrowings greater than 90 days
Proceeds from the issuance of trust preferred securities
Net proceeds from preferred stock offering
Payment of preferred stock dividends
Purchases of treasury stock
Proceeds from exercised common stock options

Net cash provided by financing activities

Increase in cash and cash equivalents

Cash and cash equivalents:
Beginning of period

End of period $

Supplemental disclosures:
Cash payments for:
Interest expense $
Taxes

Supplemental disclosure of noncash activities:
Change in the estimated fair value of investment securities available for sale $
Change in deferred tax asset related to investment securities available for sale
Tax effect of exercised common stock options
Transfer of loans to other real estate owned

The accompanying notes are an integral part of the consolidated financial statements.

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PREMIER BANCORP, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

1. ORGANIZATION

Premier Bancorp, Inc. (PBI) is a Pennsylvania business corporation and a registered financial holding company headquartered in Doylestown, Bucks County, Pennsylvania. PBI was incorporated on July 15, 1997 and reorganized on November 17, 1997 as the one-bank holding company of Premier Bank. PBI elected financial holding company status in December 2000. PBI's primary business is the operation of its wholly-owned subsidiary, Premier Bank, which is managed as a single business segment.

Premier Bank provides a full range of banking services to individual and corporate customers through its branch banking system located in Bucks, Montgomery and Northampton Counties in Pennsylvania. Premier Bank is a Pennsylvania chartered commercial bank and a member of the Federal Reserve Bank of Philadelphia. Premier Bank's deposits are insured to the legal limits by the Federal Deposit Insurance Corporation. Premier Bank competes with other financial institutions and other financial services companies with respect to customers and services offered.

Both PBI and Premier Bank are regulated and periodically examined by certain federal and state agencies.

2. BASIS OF FINANCIAL STATEMENT PRESENTATION

The accompanying unaudited consolidated financial statements of PBI have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. The consolidated financial statements include the accounts of Premier Bancorp, Inc. and its wholly-owned subsidiaries: Premier Bank, PBI Capital Trust, Premier Capital Trust II, Lenders Abstract, LLC and Premier Bank Insurance Services, LLC. In the opinion of management, the accompanying unaudited financial statements contain all material adjustments, including elimination of all significant intercompany accounts and transactions, necessary to present fairly PBI's financial position, results of operations and cash flows for the periods indicated, and have been prepared in a manner consistent with the audited financial statements as of December 31, 2001. These results of operations for the three and nine months ended September 30, 2002 and 2001 are not necessarily indicative of the results that may be expected for the full fiscal year. These financial statements should be read in conjunction with the audited financial statements and the footnotes for the fiscal year ended December 31, 2001 included in PBI's annual report on Form 10-KSB filed with the Securities and Exchange Commission.

3. USE OF ESTIMATES

In preparing the consolidated financial statements in accordance with accounting principles generally accepted in the United States as applied to the banking industry, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from such estimates. Material estimates that are particularly susceptible to significant change in the near term include the determination of the allowance for loan losses.

4. DERIVATIVE FINANCIAL INSTRUMENTS

PBI and its subsidiaries have limited involvement with derivative financial instruments and currently use them only in relation to Premier Bank's Index Powered SM Certificate of Deposit (IPCD) product. The IPCD, which was introduced in the first quarter of 2001, contains an embedded derivative feature that provides a potential return to the depositor based upon a formula that is dependent on the return of the Standard & Poor's 500 (R) Index. This innovative 5-year term deposit product allows the customer to receive a return that is based on an equity market index in place of a stated interest rate but, like other traditional certificates of deposit, is insured by the FDIC to the extent provided by law.





4. DERIVATIVE FINANCIAL INSTRUMENTS (CONTINUED)

Premier Bank entered into derivative contracts with the Federal Home Loan Bank of Pittsburgh (FHLB) in order to offset the risks associated with the variable cost of the IPCD. Under the terms of these derivative contracts, Premier Bank will receive an amount equal to the amount to be paid to the IPCD depositor in exchange for a periodic payment stream expressed as a rate of interest.

The derivative contracts with the FHLB and the derivatives embedded in the IPCD are accounted for in accordance with Financial Accounting Standards Board Statement No. 133, "Accounting for Derivative Instruments and Hedging Activities", as amended. Accordingly, PBI carries these derivatives at fair value in the Consolidated Balance Sheets and recognizes any changes in fair value in current period earnings. We obtain the fair value estimates for these derivatives from a third party financial institution.

The notional amount of derivative contracts was $16,518,000 and $10,905,000 at September 30, 2002 and December 31, 2001, respectively. The fair value of derivatives is included in "Other liabilities" and approximated $2,744,000 and $2,055,000 at September 30, 2002 and December 31, 2001, respectively. During the three and nine months ended September 30, 2002 approximately $84,000 and $179,000, respectively, was recorded in other expense for net changes in the fair value of derivatives compared to $61,000 and $83,000 in expense for the three and nine months ended September 30, 2001, respectively. The fair value adjustments are due to changes in prevailing interest rates and the resulting valuations of future payments due to the FHLB.

5. EARNINGS PER COMMON SHARE

Basic earnings per common share is calculated on the basis of the weighted average number of common shares outstanding. Diluted earnings per common share includes dilutive common stock equivalents as computed under the treasury stock method using average common stock prices for the respective period. Options to purchase 303,748 and 556,278 shares of common stock were outstanding at September 30, 2002 and 2001, respectively, and to the extent dilutive, were included in the computation of earnings per diluted common share. Options to purchase 51,998 shares of common stock were anti-dilutive and were excluded from the calculation of earnings per diluted common share for the first and second quarters of 2002. There were no anti-dilutive options for the third quarter ended September 30, 2002. Options to purchase 51,998 shares of common stock were anti-dilutive and excluded from the calculation of earnings per diluted common share for the first, second and third quarters of 2001.

Earnings per common share are reduced by the amount of preferred stock dividends declared, if any. There were $149,000 in preferred stock dividends declared and paid during the three and nine months ended September 30, 2002.



PREMIER BANCORP, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

5. EARNINGS PER COMMON SHARE (CONTINUED)

The following is a reconciliation of the numerators and denominators of the basic and diluted earnings per common share calculations.

| FOR THE THREE MONTHS ENDED SEPTEMBER 30, 2002 | NET INCOME APPLICABLE TO COMMON SHAREHOLDERS | COMMON SHARES |
|---|---|---|

| | | |
|---|---|---|
| | (DOLLARS IN THOUSANDS, EXCEPT S | |
| Basic earnings per common share | $1,113 | 3,401,023 |
| Effect of dilutive common stock options | - | 123,605 |
| Diluted earnings per common share | $1,113 | 3,524,628 |

| FOR THE THREE MONTHS ENDED SEPTEMBER 30, 2001 | NET INCOME APPLICABLE TO COMMON SHAREHOLDERS | COMMON SHARES |
|---|---|---|
| | (DOLLARS IN THOUSANDS, EXCEPT S | |
| Basic earnings per common share | $ 790 | 3,224,960 |
| Effect of dilutive common stock options | - | 253,283 |
| Diluted earnings per common share | $ 790 | 3,478,243 |

| FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2002 | NET INCOME APPLICABLE TO COMMON SHAREHOLDERS | COMMON SHARES |
|---|---|---|
| | (DOLLARS IN THOUSANDS, EXCEPT S | |
| Basic earnings per common share | $3,058 | 3,373,236 |
| Effect of dilutive common stock options | - | 126,841 |
| Diluted earnings per common share | $3,058 | 3,500,077 |

| FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2001 | NET INCOME APPLICABLE TO COMMON SHAREHOLDERS | COMMON SHARES |
|---|---|---|
| | (DOLLARS IN THOUSANDS, EXCEPT S | |
| Basic earnings per common share | $1,819 | 3,207,402 |
| Effect of dilutive common stock options | - | 223,225 |
| Diluted earnings per common share | $1,819 | 3,430,627 |



PREMIER BANCORP, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

6. COMPREHENSIVE INCOME

The following table displays net income and the components of other comprehensive income to arrive at total comprehensive income. The only component of other comprehensive income is the change in the estimated fair value of investment securities available for sale.

| | FOR THE THREE MONTHS ENDED SEPTEMBER 30, 2002 | SEPTEMBER 30, 2001 | SEPT |
|---|---|---|---|
| | (Dollars in thousands) | | |
| Net income | $1,262 | $ 790 | |
| Other comprehensive income, net of tax: | | | |
| Unrealized gains on investment securities available for sale: | | | |
| Unrealized holding gains during the period | 626 | 980 | |
| Reclassification adjustment for gains included in net income | (56) | (2) | |
| Other comprehensive income, net of tax | 570 | 978 | |
| Comprehensive income | $1,832 | $1,768 | |

7. PREFERRED STOCK

On June 19, 2002, PBI completed its public offering of 552,000 shares of Series A 9.25% Non-Cumulative Perpetual Preferred Stock at $25.00 per share. PBI's Series A Preferred Stock trades on the AMEX under the symbol PPA.Pr.A. Dividends on the Series A Preferred Stock, if declared by the board of directors, are payable quarterly.

On July 11, 2002, PBI's board of directors approved a cash dividend of $0.2698 per share to preferred shareholders of record on July 16, 2002. This dividend, totaling $149,000, was paid on July 31, 2002 and represented payment for the period from June 19, 2002 to July 30, 2002.

On October 7, 2002, PBI's board of directors approved a cash dividend of $0.578125 per share or $319,000 to preferred shareholders of record on October 16, 2002. This dividend was paid on October 31, 2002 and represented payment for the quarter August 1, 2002 through October 31, 2002.

8. COMMON STOCK BUY-BACK PROGRAM

On July 11, 2002, PBI's board of directors approved a plan to purchase up to 4.9% of its outstanding common stock in the open market or in privately negotiated transactions.

On October 22, 2002, PBI's board of directors announced the termination of its stock repurchase program after the repurchase of 109,858 shares at an average price of $12.00 per share during the third quarter of 2002. These stock repurchases are presented as "Treasury stock" in the Consolidated Balance Sheets.

PREMIER BANCORP, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

9. CAPITAL SECURITIES

Capital securities totaled $25,000,000 at September 30, 2002 and were comprised of two issues. Proceeds from the capital securities provide PBI with additional Tier 1 and Tier 2 capital as determined by regulatory capital guidelines.

On September 26, 2002, PBI's subsidiary, Premier Capital Trust II, issued $15,000,000 of variable rate corporate securities due November 30, 2032. The trust is a Delaware statutory business trust. PBI is the sole owner of the trust. The trust used the proceeds from the capital securities to acquire $15,000,000 in variable rate junior subordinated deferrable interest debentures issued by PBI. The interest rate on both the capital securities and junior subordinated debentures is based on the 90-day LIBOR index plus 345 basis points. At September 30, 2002 the interest rate was 5.25%. The junior subordinated debentures are the sole assets of the trust and payments under the junior subordinated debentures are the sole revenue of the trust.

In August 1998, PBI Capital Trust issued $10,000,000 in 8.57% capital securities due August 15, 2028.



ITEM 2 -- MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following is management's discussion and analysis of the significant changes in the results of operations for the three and nine months ended September 30, 2002 as compared to the same periods in 2001 and changes in the balance sheet from December 31, 2001 to September 30, 2002. Current performance may not be indicative of future performance. This discussion should be read in conjunction with PBI's 2001 Annual Report on Form 10-KSB.

Management has made forward-looking statements in this Quarterly Report on Form 10-Q. These forward-looking statements may be subject to risks and uncertainties. Forward-looking statements include the information concerning possible or assumed future results of operations of Premier Bancorp, Inc. and its subsidiaries, Premier Bank, PBI Capital Trust, Premier Capital Trust II, Lenders Abstract, LLC and Premier Bank Insurance Services, LLC. When words such as "believes", "expects", "anticipates" or similar expressions occur in this Form 10-Q, management is making forward-looking statements.

Shareholders should note that many factors, some of which are discussed elsewhere in this Form 10-Q, could affect the future financial results of PBI and its subsidiaries, both individually and collectively, and could cause those results to differ materially from those expressed in the forward-looking statements contained in this Form 10-Q. These factors include but are not limited to the following:

- operating, legal and regulatory risks, such as continued levels of loan quality and origination volumes, continued relationships with major customers, and technological changes;

- economic, political and competitive forces affecting Premier Bank's business, such as changes in economic conditions, especially in the bank's market area, interest rate fluctuations, competitive product and pricing pressures within the bank's market, personal and corporate bankruptcies, monetary policy and inflation;

- our ability to grow internally or through acquisitions; and

- the risk that management's analyses of these risks and forces could be incorrect and/or that the strategies developed to address them could be unsuccessful.

Management cautions readers not to place undue reliance on these forward-looking statements that reflect its analysis only as of this date. Management is not obliged to publicly revise or update these forward-looking statements to reflect events or circumstances that arise after this date. Readers should carefully review the risk factors described in other documents that we file from time to time with the Securities and Exchange Commission, including Annual Reports on Form 10-K and any current reports on Form 8-K.

GENERAL

Premier Bancorp, Inc. (PBI) is a Pennsylvania business corporation and a registered financial holding company headquartered in Doylestown, Bucks County, Pennsylvania. We were incorporated on July 15, 1997 and reorganized on November 17, 1997 as the one-bank holding company of Premier Bank. Our primary business is the operation of our wholly-owned subsidiary, Premier Bank, which we manage as a single business segment.

Premier Bank was organized in 1990 as a Pennsylvania chartered banking institution and began operations on April 24, 1992. The bank is a financial services provider whose business primarily consists of attracting retail deposits from the general public and originating loans to small to mid-sized businesses and their owners. The bank also invests in securities such as mortgage-backed securities, obligations of U.S. government agencies and government sponsored entities, corporate bonds and municipal bonds.

Premier Bank's revenues are derived principally from interest on its loan and securities portfolios. The bank's primary sources of funds are deposits, repayments of loans and investment securities, and borrowed funds. Premier Bank has seven full-service Pennsylvania banking offices: Doylestown, Easton, Southampton, Bethlehem, Floral Vale, Bensalem and Montgomeryville. The bank also operates a limited service branch in the Heritage Towers Retirement Community in Doylestown. Premier Bank faces significant competition from other financial services companies, many of which are larger organizations with more resources and locations.

Our consolidated results of operations are dependent primarily on net interest income, which is the difference between the interest income earned on interest-earning assets, such as loans and securities, and the interest expense paid on interest-bearing liabilities, such as deposits and borrowed money. We also generate non-interest income such as service charges on deposit products, fees from sales of title insurance and other fees. Our non-interest



expenses primarily consist of employee compensation and benefits, occupancy expenses, marketing, data processing costs and other operating expenses. The bank is subject to losses from its loan and investment portfolios if borrowers/issuers fail to meet their obligations or if the market value of its investment securities declines. Our results of operations are also significantly affected by general economic and competitive conditions, particularly changes in market interest rates, government policies and actions of regulatory agencies.

## MANAGEMENT'S STRATEGY

Premier Bank's lending activities are specialized in small to mid-sized businesses and professionals. The bank seeks to fund these activities by developing a stable core deposit base catering primarily to retail and small to mid-sized business depositors. Premier Bank has a strong commitment to highly personalized customer service. To support its growth, without compromising personalized service, Premier Bank has made significant investments in experienced personnel and has incurred significant costs related to branch office expansion. Since Premier Bank's 1992 inception, it has grown to seven full-service Pennsylvania banking offices and has significantly added to its commercial lending staff.

PBI buys and sells investment securities from time to time depending on market conditions, business trends, liquidity and capital levels. Investment purchases provide a way to add assets quickly and generate additional earnings. While our ultimate goal is loan growth, the development of a quality loan portfolio requires significant time. During the third quarter of 2002, we increased the investment portfolio by $67,324,000 due to excess liquidity from deposit growth, new borrowings and proceeds from our trust preferred securities issuance.

In addition to the ongoing expansion of the bank's traditional business, management continuously reviews and considers new products and services to offer customers. These new products and services are largely intended to generate and increase fee income. In December 2000, we organized Lenders Abstract, LLC to generate fee income from the sales of title insurance policies. Substantially all of Lenders Abstract, LLC's business to date has been derived from Premier Bank's customers. During the three and nine months ended September 30, 2002, Lenders Abstract, LLC generated fee income of $29,000 and $115,000, respectively.

In March 2002, we organized Premier Bank Insurance Services, LLC to further diversify our products and services. This subsidiary primarily sells long-term health care insurance policies on an agency basis. Premier Bank Insurance Services, LLC commenced operations in June 2002.

Recent changes to federal banking laws allow financial institutions to engage in a broader range of activities than previously permitted. These legislative changes may serve to increase both opportunity as well as competition.

## CRITICAL ACCOUNTING POLICIES

The following discussion and analysis of our financial condition and results of operations is based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires management to make estimates and judgments that affect the reported amounts of assets and liabilities, revenues and expenses, and related disclosures of contingent assets and liabilities at the date of the financial statements. Actual results may differ from these estimates under different assumptions and conditions.

In management's opinion, the most critical accounting policies impacting PBI's consolidated financial statements are:

Evaluation of the allowance for loan losses

The loan loss allowance policy involves significant judgments and assumptions by management that may have a material impact on the carrying value of net loans and, potentially, on the net income recognized from period to period. For a description of our accounting policies and estimation methodology related to the allowance for loan losses, see "Allowance for loan losses," below.



Accrual and recognition of interest on loans

These policies involve significant judgments and assumptions by management, which may have a material impact on the interest income recognized from period to period. For a description of our accounting policies in connection with accrual and recognition of interest on loans, see Note 1 (Summary of Significant Accounting Policies) to PBI's audited consolidated financial statements for the fiscal year ended December 31, 2001 (the "Annual Financial Statements") included in Form 10-KSB for the year ended December 31, 2001.

Realization of deferred income tax items

Estimates of deferred tax assets and deferred tax liabilities make up the asset category titled, "Deferred income taxes." These estimates involve significant judgments and assumptions by management, which may have a material impact on the carrying value of deferred tax assets for financial reporting purposes. For a more detailed description of these items and estimates, see Note 13 (Income Taxes) to the Annual Financial Statements included in Form 10-KSB for the year ended December 31, 2001.

Unrealized gains and losses on debt securities available for sale

We receive estimated fair values of debt securities from an independent valuation service and brokers. In developing these fair values, the valuation service and brokers use estimates of cash flows based on historical performance of similar instruments in similar rate environments. Based on experience, management is aware that estimated fair values of debt securities vary among brokers and other valuation services. Debt securities available for sale are mostly comprised of mortgage-backed securities and corporate bonds. For more detail on the estimated fair value of debt securities, see "Investment securities," below.

The Notes to our consolidated financial statements set forth herein and in the Annual Financial Statements identify other significant accounting policies used in the development and presentation of our financial statements. This discussion and analysis, the significant accounting policies and other financial statement disclosures identify and address key variables and other qualitative and quantitative factors that are necessary for an understanding and evaluation of our results of operations.

RESULTS OF OPERATIONS

We reported net income applicable to common shareholders of $1,113,000 or $.32 earnings per common share on a diluted basis for the three months ended September 30, 2002. This represents an increase of $323,000 or 41% from the net income applicable to common shareholders of $790,000 or $.23 earnings per common share on a diluted basis reported for the same period in 2001. Net interest income was $1,147,000 higher in 2002 compared to 2001 due to a $119,381,000 or 30% increase in average interest-earning assets. Loans accounted for $77,776,000 of the growth in average interest-earning assets. During the third quarter of 2002 we recorded $172,000 in deferred fee income related to renegotiated loans which was partially offset by $84,000 in interest income reversals on non-accrual loans. Excluding these items, the net interest margin compressed by 6 basis points from 3.58% during the three months ended September 30, 2001 to 3.52% during the same period in 2002. The net interest spread, excluding deferred fee income on renegotiated loans and interest income reversals on non-accrual loans, increased by 16 basis points from 2.96% for the three months ended September 30, 2001 to 3.12% for the three months ended September 30, 2002. Non-interest income was $257,000 for the three months ended September 30, 2002 compared to $138,000 for the same period in 2001. Non-interest income was $119,000 or 86% higher in 2002 due primarily to gains on the sales of investment securities available for sale. Non-interest expenses were $2,775,000 for the three months ended September 30, 2002 compared to $2,362,000 for the same period in 2001. Non-interest expenses were $413,000 or 17% higher in 2002 due in part to the overall growth of the company.

We reported net income applicable to common shareholders of $3,058,000 or $.87 earnings per common share on a diluted basis for the nine months ended September 30, 2002. This represents an increase of $1,239,000 or 68% from the net income applicable to common shareholders of $1,819,000 or $.53 earnings per common share on a diluted basis reported for the same period in 2001. Net interest income was $3,092,000 higher in 2002 compared to 2001 due to a $105,270,000 or 28% increase in average interest-earning assets, a wider net interest rate spread and a



wider net interest margin. Loans accounted for $82,354,000 of the growth in average interest-earning assets. During the nine months ended September 30, 2002 we recorded $172,000 in deferred fee income related to renegotiated loans which was partially offset by $105,000 in interest income reversals on non-accrual loans. Excluding these items, our net interest rate spread increased 33 basis points from 2.83% for the nine months ended September 30, 2001 to 3.16% for the same period in 2002. Our net interest margin, excluding deferred fee income on renegotiated loans and interest income reversals on non-accrual loans, increased 7 basis points from 3.52% for the nine months ended September 30, 2001 to 3.59% for the same period in 2002. Non-interest income was $703,000 for the nine months ended September 30, 2002 compared to $424,000 the same period in 2001. Non-interest income was $279,000 or 66% higher in 2002 due primarily to an increase in service charges and other deposit related fees and gains from the sales of an SBA loan, other real estate owned and investment securities available for sale. Non-interest expenses were $7,954,000 for the nine months ended September 30, 2002 compared to $6,964,000 for the same period in 2001. Non-interest expenses were $990,000 or 14% higher in 2002 due in part to the overall growth of the company.

Return on average assets and return on average equity on an annualized basis are presented in the following table for the three and nine months ended September 30, 2002 and 2001.

| | FOR THE THREE MONTHS ENDED SEPTEMBER 30, 2002 | FOR THE THREE MONTHS ENDED SEPTEMBER 30, 2001 | FOR THE N ENDED SE 2002 |
|---|---|---|---|
| Return on Average Assets (1) | 0.81% | 0.76% | 0.82% |
| Return of Average Common Equity (2) | 18.61% | 16.50% | 18.49% |
| Return of Average Common Equity, excluding SFAS 115 valuation allowance (3) | 17.64% | 14.56% | 16.88% |

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(1) Calculated as net income after preferred stock dividends divided by average assets.

(2) Calculated as net income after preferred stock dividends divided by average total equity less prefered stock.

(3) Calculated as net income after preferred stock dividends divided by average total equity less preferred stock plus unrealized loss on AFS securities.

Net interest income

Net interest income is the most significant component of our operating income. Net interest income depends upon the levels of interest-earning assets and interest-bearing liabilities and the difference or "spread" between the respective yields earned and rates paid. The interest rate spread is influenced by the overall interest rate environment, the composition and characteristics of interest-earning assets and interest-bearing liabilities, and by competition. The interest rate spread is also influenced by differences in the maturity and repricing of assets versus the liabilities that fund them.

Responding to generally weak economic conditions, the Federal Reserve cut the targeted federal funds rate by an unprecendented 4.75% to a rate of 1.75% in 2001. As a result, the current interest rate environment is at one of its all time historic low levels. The bank's interest-earning assets and interest-bearing liabilities continue to originate and reprice in this lower rate environment. The yields on average loans for the three and nine months ended September 30, 2002 were 7.42% and 7.47%, respectively, compared to 8.28% and 8.54%, respectively, for the three and nine months ended September 30, 2001. Similarly, the yields on average investments for the three and nine months ended September 30, 2002 were 5.74% and 6.15%, respectively, compared to 6.83% and 6.93%, respectively, for the three and nine months ended September 30, 2001 due in part to the repricing of variable rate securities and the restructuring of the portfolio at current rates. The rate on average interest-bearing liabilities declined from 4.78% for the three months ended September 30, 2001 to 3.32% for same period in 2002 and from 5.16% for the nine months ended September 30, 2001 to 3.61% for the same period in 2002 due in part to lower rates. In the current environment we had considerable success in raising non-maturity deposits that are generally less costly than time deposits.



For the three and nine months ended September 30, 2002, net interest income, on a tax-equivalent basis, was $1,093,000 and $3,065,000 higher, respectively, than the same periods in 2001. The increase in net interest income in 2002 was primarily a function of interest-earning asset growth and a lower yield on average interest-bearing liabilities. In addition, net interest income for the three and nine months ended September 30, 2002 was positively impacted by the net of deferred fees on renegotiated loans and interest income reversals on non-accrual loans. These items added $88,000 and $67,000 to interest income on loans for the three and nine months ended September 30, 2002, respectively. These favorable items were offset in part by a lower rate on average interest-earning assets and a lower ratio of average interest-earning assets to average interest-bearing liabilities.

Average interest-earning assets grew $119,381,000 or 30% from $400,285,000 for the three months ended September 30, 2001 to $519,666,000 for the three months ended September 30, 2002. Average loan balances, average interest-bearing deposits, average short-term investments, and average investment balances increased $77,776,000, $24,630,000, $11,627,000 and $5,348,000, respectively. The ratio of average interest-earning assets to average interest-bearing liabilities decreased from 115.03% for the three months ended September 30, 2001 to 113.75% for the three months ended September 30, 2002. The yield on average interest-earning assets and the rate on average interest-bearing liabilities decreased 123 basis points and 146 basis points, respectively, due to the decline in overall interest rates in 2001. Excluding deferred fee income on renegotiated loans and interest income reversals on non-accrual loans, the yield on interest earning assets decreased 130 basis points. The decrease in rate on average interest-bearing liabilities is mostly due to the repricing of certificates of deposit in the lower interest rate environment, the change in deposit mix and new long-term borrowings at lower rates. Short-term borrowings and subordinated debt also repriced lower in 2002.

The net interest margin on a tax equivalent basis was virtually unchanged at 3.59% for the three months ended September 30, 2002 compared to 3.58% for the same period in 2001. Excluding deferred fee income on renegotiated loans and interest income reversals on non-accrual loans, the net interest margin compressed by 6 basis points to 3.52% for the three months ended September 30, 2002. The net interest rate spread increased 23 basis points from 2.96% for the three months ended September 30, 2001 to 3.19% for the same period in 2002. Excluding deferred fee income on renegotiated loans and interest income reversals on non-accrual loans, the net interest rate spread improved 16 basis points to 3.12% during the three months ended September 30, 2002.

Average interest-earning assets grew $105,270,000 or 28% from $375,095,000 for the nine months ended September 30, 2001 to $480,365,000 for the nine months ended September 30, 2002. Average loan balances, average interest-bearing deposits and average short-term investments increased $82,354,000, $14,281,000 and $9,069,000, respectively. The ratio of average interest-earning assets to average interest-bearing liabilities decreased from 115.59% for the nine months ended September 30, 2001 to 113.38% for the nine months ended September 30, 2002. The yield on average interest-earning assets and the rate on average interest-bearing liabilities decreased 120 basis points and 155 basis points, respectively, due to the decline in overall interest rates in 2001. Excluding deferred fee income on renegotiated loans and interest income reversals on non-accrual loans, the yield on interest earning assets decreased 122 basis points. The decrease in rate on average interest-bearing liabilities is mostly due to the repricing of certificates of deposit in the lower interest rate environment, the change in deposit mix and new long-term borrowings at lower rates. Short-term borrowings and subordinated debt also repriced lower in 2002.

The net interest margin on a tax equivalent basis increased 9 basis points from 3.52% for the nine months ended September 30, 2001 to 3.61% for the same period in 2002. Excluding deferred fee income on renegotiated loans and interest income reversals on non-accrual loans, the net interest margin increased by 7 basis points to 3.59% for the nine months ended September 30, 2002. The net interest rate spread increased 35 basis points from 2.83% for the nine months ended September 30, 2001 to 3.18% for the same period in 2002. Excluding deferred fee income on renegotiated loans and interest income reversals on non-accrual loans, the net interest rate spread improved 33 basis points to 3.16% during the nine months ended September 30, 2002.



The following tables set forth, for the periods indicated, certain average balance sheet amounts and their corresponding earnings/expenses and rates (which have been annualized).

AVERAGE BALANCES, RATES AND INTEREST INCOME AND EXPENSE SUMMARY

| | FOR THE THREE MONTH | | | |
|---|---|---|---|---|
| | 2002 | | | |
| | AVERAGE BALANCE | INTEREST | AVERAGE RATE | A B |
| | | | (Dollars in t | |
| Assets: | | | | |
| Short-term investments | $ 22,287 | $ 92 | 1.64% | $ |
| Interest-bearing deposits | 25,931 | 102 | 1.56% | |
| Investment securities available for sale | | | | |
| Taxable (1) | 102,944 | 1,432 | 5.52% | |
| Tax-exempt (1) (2) | 12,667 | 240 | 7.52% | |
| Investment securities held to maturity | 500 | 7 | 5.55% | |
| Total investment securities | 116,111 | 1,679 | 5.74% | |
| Loans, net of unearned income (3) (4) | 355,337 | 6,649 | 7.42% | |
| Total interest-earning assets | 519,666 | 8,522 | 6.51% | |
| Cash and due from banks | 19,115 | | | |
| Allowance for loan losses | (4,377) | | | |
| Other assets (5) | 9,566 | | | |
| Total assets | $543,970 | | | $ |
| Liabilities, minority interest in subsidiaries and shareholders' equity: | | | | |
| Interest checking | $137,845 | 986 | 2.84% | $ |
| Money market deposit accounts | 16,918 | 97 | 2.27% | |
| Savings accounts | 50,510 | 286 | 2.25% | |
| Time deposits | 185,583 | 1,810 | 3.87% | |
| Total interest-bearing deposits | 390,856 | 3,179 | 3.23% | |
| Short-term borrowings | 21,418 | 41 | 0.76% | |
| Long-term borrowings | 41,087 | 550 | 5.31% | |
| Subordinated debt | 3,500 | 49 | 5.55% | |
| Total borrowings | 66,005 | 640 | 3.85% | |
| Total interest-bearing liabilities | 456,861 | 3,819 | 3.32% | |
| Non interest-bearing deposits | 31,118 | | | |
| Other liabilities | 7,797 | | | |
| Capital securities | 10,815 | | | |
| Shareholders' equity (6) | 37,379 | | | |
| Total liabilities, minority interest in subsidiaries and shareholders' equity | $543,970 | | | $ |
| Net interest income/rate spread | | $4,703 | 3.19% | |
| Net interest margin (7) | | | 3.59% | |
| Average interest-earning assets as a percentage of average interest-bearing liabilities | 113.75% | | | |

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(1) Excludes the SFAS 115 valuation allowance on investment securities available for sale.

(2) Interest income on tax-exempt investment securities was presented on a tax-equivalent basis. Tax-exempt yields were adjusted to a tax equivalent basis using a 34% rate.

(3) Includes non-accrual loans of $3,610,000 and $244,000 on average for the three months ended September 30, 2002 and 2001, respectively.

(4) Includes tax-exempt loans of $2,202,000 and $2,416,000 on average for the three months ended September 30, 2002 and 2001, respectively. Tax-exempt yields were adjusted to a tax-equivalent basis using a 34% rate.

(5) Excludes the deferred tax asset related to the SFAS 115 valuation allowance on investment securities available for sale.

(6) Excludes the SFAS 115 valuation allowance on investment securities available for sale, net of tax.

(7) Net interest margin is calculated as net interest income divided by average interest-earning assets.



AVERAGE BALANCES, RATES AND INTEREST INCOME AND EXPENSE SUMMARY

| | FOR THE NINE MONTHS END | | | |
|---|---|---|---|---|
| | 2002 | | | |
| | AVERAGE BALANCE | INTEREST | AVERAGE RATE | A B |
| | | | (Dollars in tho | |
| Assets: | | | | |
| Short-term investments | $17,316 | $ 229 | 1.77% | $ |
| Interest-bearing deposits | 15,081 | 177 | 1.57% | |
| Investment securities available for sale | | | | |
| Taxable (1) | 88,181 | 3,873 | 5.87% | |
| Tax-exempt (1) (2) | 16,824 | 956 | 7.60% | |
| Investment securities held to maturity | 500 | 22 | 5.88% | |
| Total investment securities | 105,505 | 4,851 | 6.15% | 1 |
| Loans, net of unearned income (3) (4) | 342,463 | 19,142 | 7.47% | 2 |
| Total interest-earning assets | 480,365 | 24,399 | 6.79% | 3 |
| Cash and due from banks | 15,816 | | | |
| Allowance for loan losses | (4,171) | | | |
| Other assets (5) | 9,837 | | | |
| Total assets | $501,847 | | | $3 |
| Liabilities, minority interest in subsidiaries and shareholders' equity: | | | | |
| Interest checking | $110,297 | 2,334 | 2.83% | $ |

| | | | | |
|---|---|---|---|---|
| Money market deposit accounts | 16,725 | 287 | 2.29% | |
| Savings accounts | 48,268 | 807 | 2.24% | |
| Time deposits | 192,241 | 6,330 | 4.40% | 2 |
| Total interest-bearing deposits | 367,531 | 9,758 | 3.55% | 2 |
| Short-term borrowings | 18,914 | 108 | 0.76% | |
| Long-term borrowings | 33,736 | 1,433 | 5.68% | |
| Subordinated debt | 3,500 | 147 | 5.62% | |
| Total borrowings | 56,150 | 1,688 | 4.02% | |
| Total interest-bearing liabilities | 423,681 | 11,446 | 3.61% | 3 |
| Non interest-bearing deposits | 30,116 | | | |
| Other liabilities | 8,831 | | | |
| Capital securities | 10,275 | | | |
| Shareholders' equity (6) | 28,944 | | | |
| Total liabilities, minority interest in subsidiaries and shareholders' equity | $501,847 | | | $3 |
| Net interest income/rate spread | | $12,953 | 3.18% | |
| Net interest margin (7) | | | 3.61% | |
| Average interest-earning assets as a percentage of average interest-bearing liabilities | 113.38% | | | |

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(1) Excludes the SFAS 115 valuation allowance on investment securities available for sale.

(2) Interest income on tax-exempt investment securities was presented on a tax-equivalent basis. Tax-exempt yields were adjusted to a tax equivalent basis using a 34% rate.

(3) Includes non-accrual loans of $2,876,000 and $132,000 on average for the nine months ended September 30, 2002 and 2001, respectively.

(4) Includes tax-exempt loans of $2,232,000 and $1,543,000 on average for the nine months ended September 30, 2002 and 2001, respectively. Tax-exempt yields were adjusted to a tax-equivalent basis using a 34% rate.

(5) Excludes the deferred tax asset related to the SFAS 115 valuation allowance on investment securities available for sale.

(6) Excludes the SFAS 115 valuation allowance on investment securities available for sale, net of tax.

(7) Net interest margin is calculated as net interest income divided by average interest-earning assets.

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Non-interest income

Non-interest income consists primarily of service charges and other deposit related fees, fees from sales of title insurance policies and gains (losses) on the sale of investment securities available for sale, loans held for sale and other real estate owned.

For the three months ended September 30, 2002, non-interest income was $257,000 or $119,000 higher than the $138,000 recorded during the same period in 2001. During 2002, we recorded $85,000 in gains on the sale of investment securities available for sale compared to $3,000 in 2001. Service charges and other deposit-related fees were $20,000 higher for the three months ended September 30, 2002 compared to the same period in 2001.

For the nine months ended September 30, 2002, non-interest income was $703,000 or $279,000 higher than the $424,000 recorded during the same period in 2001. In 2001, non-interest income included $50,000 in fees related to a loan pay-off. Excluding this non-recurring 2001 fee, non-interest income increased $329,000 or 88% in 2002. Of this increase, $53,000 pertained to service charges and activities related to deposit accounts which have grown considerably in the past year and $46,000 to the gain on the sale of a small business administration loan. Fees from sales of title insurance policies by Lenders Abstract, LLC were $18,000 higher in 2002 due to greater volume. During 2002 we recorded $124,000 in gains on the sale of investment securities available for sale compared to no gains during 2001. In addition, we recorded $33,000 in gains on the sale of other real estate owned in 2002 compared to $17,000 in losses in 2001.

Non-interest expense

For the three months ended September 30, 2002, non-interest expenses were $2,775,000 or $413,000 higher than the $2,362,000 recorded during the same period in 2001. For the nine months ended September 30, 2002, non-interest expenses were $7,954,000 or $990,000 higher than the $6,964,000 recorded during the same period in 2001. Non-interest expenses in 2002 increased principally due to the continued growth of the company.

Salaries and benefits were $259,000 or 24% higher in the third quarter of 2002 compared to the same period in 2001. This increase was principally due to an increase in the number of employees, salary adjustments and higher health insurance costs. The number of full-time equivalent employees grew from 78 at September 30, 2001 to 90 at September 30, 2002. Data processing expenses increased $60,000 primarily due to the growth of the company, variable costs associated with item processing and account volumes, and new services. Other expenses, which consist primarily of furniture and equipment expense, employee travel, meals and entertainment, stationery, supplies, postage and Board of Directors' fees, increased $92,000 or 20% compared to the third quarter of 2001. Of this increase, $23,000 pertained to the fair market adjustment of derivatives related to Premier Bank's IPCD. The remaining increase is primarily attributed to the growth of the company.

Salaries and benefits were $636,000 or 19% higher for the nine months ended September 30, 2002 compared to the same period in 2001. This increase was principally due to an increase in the number of employees, salary adjustments and higher health insurance costs. Data processing expenses increased $126,000 primarily due to the growth of the company, variable costs associated with item processing and account volumes, and new services. Marketing expenses were $80,000 lower in 2002 compared to the same period in 2001. Advertising expenses were reduced because deposit growth exceeded expectations. Other expenses increased $305,000 or 26% in 2002 compared to 2001. Of this increase, $96,000 pertained to the fair market adjustment of derivatives related to Premier Bank's IPCD. The remaining increase is primarily attributed to the growth of the company.

Provision for loan losses

The provision for loan losses represents the amount necessary to be charged to operations to bring the allowance for loan losses to a level that represents management's best estimate of known and inherent losses in the bank's loan portfolio. The amount of the allowance for loan losses is subject to ongoing analysis of the loan portfolio, which considers current economic conditions, actual loss experience, the current risk profile of the portfolio, delinquency statistics, and the composition of loan types within the portfolio. The bank's loan portfolio is relatively immature given its recent growth rates. Therefore, charge-off and non-performing trends may not be indicative of future performance.

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The provision for loan losses was $245,000 and $770,000 for the three and nine months ended September 30, 2002, respectively, compared to $179,000 and $518,000 for the same periods in 2001. The amount of the loan loss provision for the three and nine months ended September 30, 2002 was higher than the comparable periods in 2001 primarily due to an increase in non-performing loans and higher net charge offs. Non-performing loans totaled $5,123,000 at September 30, 2002 compared to $0 at September 30, 2001. Net charge-offs were $454,000 for the nine months ended September 30, 2002 compared to $33,000 for the same period in 2001.

The loan loss allowance as a percentage of total loans was 1.15% at September 30, 2002 and 1.21% at September 30, 2001.

Income tax expense

We recorded a $581,000 tax provision representing an effective tax rate of 31.5% for the three months ended September 30, 2002 compared to $266,000 or 25.2% for the same period in 2001. We recorded a $1,351,000 tax provision representing an effective tax rate of 29.6% for the nine months ended September 30, 2002 compared to $610,000 or 25.1% for the same period in 2001. The effective tax rates for the three and nine months ended September 30, 2002 were higher than the comparable periods in 2001 principally due to a lower ratio of tax-exempt interest to total pre-tax income. Our statutory federal tax rate is 34%.

FINANCIAL CONDITION

Consolidated assets grew $148,807,000 or 33% during the nine months ended September 30, 2002 to $599,376,000. During this period we raised $27,345,000 in new capital through the issuance of preferred stock and capital securities. This new capital, together with a $76,065,000 increase in deposits, mostly interest checking accounts, and a $30,000,000 increase in long-term FHLB advances, funded our asset growth. Investments, total gross loans and cash and cash equivalents grew $67,324,000, $43,578,000 and $37,663,000, respectively, during the nine months ended September 30, 2002.

Shareholders' equity increased $16,455,000 from $19,609,000 at December 31, 2001 to $36,064,000 at September 30, 2002. This increase was attributable to $12,345,000 in net proceeds from the sale of preferred stock, $3,058,000 in earnings after preferred stock dividends, a $1,841,000 improvement in the estimated fair value of investment securities available for sale, net of tax, and $529,000 from the exercise of common stock options. Shareholders' equity was reduced by $1,318,000 due to the repurchase of common stock.

Investment securities

Investment policies dictate permissible investment categories, credit quality, maturity intervals and investment concentrations. Management is responsible for making the specific investment purchases within these standards. The carrying value of investment securities at September 30, 2002 totaled

$165,675,000 or 28% of total assets. At September 30, 2002 approximately 56% of the investment portfolio was comprised of mortgage-backed securities that amortize and provide monthly cash flow. Corporate bonds and municipal bonds comprised 31% and 7% of the investment portfolio, respectively. At September 30, 2002, approximately 61% of the investment portfolio was fixed rate.

Management buys and sells investment securities from time to time depending on market conditions, business trends, liquidity, and capital levels. Investment purchases provide a way to add assets quickly and generate additional earnings. During the third quarter of 2002, we purchased of $101,515,000 of AFS investments using the proceeds from our two recent capital initiatives and excess liquidity from deposit growth and new long-term borrowings. Investment purchases were concentrated in mortgage-backed securities and corporate bonds. During the third quarter of 2002 we also sold $19,929,000 in AFS securities at a net gain of $85,000. The majority of these gains were recognized from the sales of certain mortgage-backed securities in order to lower our prepayment exposure.

For the nine months ended September 30, 2002 investment purchases and sales totaled $127,485,000 and $54,104,000, respectively. Net gains on sales of AFS securities were $124,000 for the nine months ended September 30, 2002.



Management classifies investment securities at the time of purchase by one of three categories: trading, available for sale (AFS) or, held to maturity (HTM). To date, management has not purchased any securities for trading purposes. Management classifies most securities as AFS even though it has no immediate intent to sell them. The AFS designation affords management the flexibility to sell securities and adjust the balance sheet in response to capital levels, liquidity needs and/or changes in market conditions. Securities AFS are marked to market in the Consolidated Balance Sheets with an adjustment to equity, net of tax, that is presented in the caption "Accumulated other comprehensive income (loss)."

At September 30, 2002, the AFS portfolio had an estimated market depreciation of $1,758,000 before tax and an equity adjustment of $1,160,000, net of tax. This represents a $1,841,000 improvement in the estimated fair value of AFS securities, net of tax, over the prior year-end primarily due to the lower rate environment. The market depreciation is concentrated in a sector of the bank's corporate bond portfolio comprised of long-term trust preferred securities issued by other financial institutions. These trust preferred securities had an unrealized loss of $2,983,000 at September 30, 2002. The market continues to discount these corporate bonds due to perceived credit risk.

Management evaluated the credit quality of corporate bond issuers prior to purchasing these securities and monitors them on an ongoing basis. Management believes that the credit quality of the corporate bond portfolio is sound and that the company will ultimately be repaid. Therefore, management views the unrealized loss in the market value of the corporate bonds as temporary. If, at some future date, management believes that this loss is other than temporary or that the recovery of the unrealized loss on corporate bonds is not probable, we will recognize the loss through earnings, which would reduce regulatory capital.

INVESTMENT PORTFOLIO

SEPTEMBER 30, 2002

| | HELD TO MATURITY | | AVAILABLE FOR SA | |
|---|---|---|---|---|
| | AMORTIZED COST | ESTIMATED FAIR VALUE | AMORTIZED COST | ESTIM FAIR |
| | (In thousands) | | | |
| Mortgage-backed securities | $ - | $ - | $ 92,276 | $ 93 |
| Municipal securities | - | - | 11,214 | 11 |
| Equity securities | - | - | 3,584 | 3 |
| Mutual funds | - | - | 5,000 | 5 |
| Corporate bonds | - | - | 54,749 | 51 |
| Other debt securities | 500 | 500 | 110 | |
| Total | $500 | $500 | $166,933 | $165 |

| | DECEMBER 31, 2001 | | | |
|---|---|---|---|---|
| | HELD TO MATURITY | | AVAILABLE FOR SA | |
| | AMORTIZED COST | ESTIMATED FAIR VALUE | AMORTIZED COST | ESTIM FAIR |
| | (In thousands) | | | |
| Mortgage-backed securities | $ - | $ - | $ 43,286 | $43 |
| Municipal securities | - | - | 20,796 | 20 |
| Equity securities | - | - | 2,023 | 2 |
| Corporate bonds | - | - | 36,184 | 32 |
| Other debt securities | 500 | 500 | 110 | |
| Total | $500 | $500 | $102,399 | $97 |



Loans

Gross loans increased $43,578,000 or 14% from $316,066,000 at December 31, 2001 to $359,644,000 at September 30, 2002.

We originate a wide variety of loans primarily to small to mid-sized businesses and professionals. Our policies as well as applicable laws and regulations require risk analysis and ongoing portfolio and credit management. The majority of our loan portfolio is collateralized, at least in part, by real estate in the greater Delaware and Lehigh Valleys of Pennsylvania and New Jersey. Real estate values are typically subject to risks associated with the general economy, among other matters.

Inherent in the lending function is the evaluation and acceptance of credit risk and interest rate risk. We manage credit risk through portfolio diversification, underwriting policies and procedures, and loan monitoring practices. We manage interest rate risk using various asset/liability modeling techniques and analyses. Most loans are adjustable rate that reset in intervals of five years or less. When possible, the bank also originates variable rate loans.

LOAN PORTFOLIO

| | SEPTEMBER 30, 2002 | | DECEMBER 31, 2001 | |
|---|---|---|---|---|
| | AMOUNT | % OF TOTAL | AMOUNT | % OF TOTAL |
| | (Dollars in thousands) | | | |
| Real estate-farmland | $ 200 | 0.06% | $ 214 | 0.07% |
| Real estate-construction | 10,291 | 2.86% | 15,911 | 5.03% |
| Real estate-residential | 33,283 | 9.26% | 30,188 | 9.55% |
| Real estate-multifamily | 20,135 | 5.60% | 15,011 | 4.75% |
| Real estate-commercial | 246,944 | 68.66% | 208,412 | 65.94% |
| Commercial | 47,737 | 13.27% | 45,238 | 14.31% |
| Consumer | 1,054 | 0.29% | 1,092 | 0.35% |
| Total loans | 359,644 | 100.00% | 316,066 | 100.00% |
| Less: | | | | |
| Deferred loan fees | (1,572) | | (1,373) | |
| Allowance for loan losses | (4,133) | | (3,817) | |
| Total loans, net | $353,939 | | $310,876 | |

Allowance for loan losses

The allowance for loan losses reflects management's best estimate of losses, both known and inherent, in the existing loan portfolio. Management's judgment is based on the evaluation of individual loans, past experience, the assessment of current economic conditions, and other relevant factors. The provision for loan losses charged to operating expenses represents the amount necessary to maintain an appropriate allowance. Loan losses are charged directly against the allowance for loan losses when loans are deemed to be uncollectible. Recoveries on previously charged-off loans are added to the allowance when received.

Estimates are used to determine the allowance for loan losses. A variety of factors are considered in establishing these estimates including current economic conditions, diversification of the loan portfolio, delinquency statistics, borrowers' perceived financial and managerial strengths, the adequacy of underlying collateral, if collateral dependent, or present value of future cash flows, and other relevant factors. Each commercial loan is assigned a specific loan loss reserve using a scoring system. This scoring system takes into consideration collateral type and value, loan to value ratios, the borrower's risk rating, and other factors previously described. Independent loan reviewers determine borrower risk ratings at the inception of each loan and monitor/update these ratings on an ongoing basis. Homogeneous loans, comprised primarily of home equity and non-real estate secured consumer loans, are analyzed in the aggregate.

Because the bank is only ten years old with a limited history of loan losses, management also uses peer group analysis to gauge the overall reasonableness of loan loss reserves. While management calculates the allowance based on specific loans or loan categories, it considers the total allowance available for losses in the entire loan portfolio. Changes in economic conditions and the financial condition of borrowers can occur quickly, and as a result, impact management's estimates.

We maintained an unallocated loan loss reserve at September 30, 2001 based on a shift in risk ratings following the hiring of an independent loan reviewer in the second quarter of 1999. This unallocated reserve was based on the assumption that additional risk factors would be identified and further changes to risk ratings would be made as this independent review process was consistently applied to the entire commercial loan portfolio over an extended period of time. We adjusted our loan scoring system in the fourth quarter of 2001 to reflect current economic conditions and trends in risk ratings over the past several years. As a result, there are no unallocated loan loss reserves at December 31, 2001 or September 30, 2002.

Regulatory authorities, as an integral part of their examinations, periodically review the allowance for loan losses. They may require additions to the allowance based upon their judgment and information available to them at the time of examination.

Management considers the allowance for loan losses to be appropriate. To comply with industry reporting requirements, management allocated the allowance for loan losses by loan categories in the table below. Management does not intend to imply that actual future charge-offs will necessarily follow this allocation or that any portion of the allowance is restricted.

ALLOWANCE FOR LOAN LOSS ALLOCATION

| | SEPTEMBER 30, 2002 | | DECEMBER 31, 2001 | | SEPTEMBER 30, | |
|---|---|---|---|---|---|---|
| | AMOUNT | % LOANS TO TOTAL LOANS | AMOUNT | % LOANS TO TOTAL LOANS | AMOUNT | % LOA TOTAL |
| | | | (Dollars in thousands) | | | |
| Balance at end of period applicable to: | | | | | | |
| Real estate-farmland | $ 1 | 0.06% | $ 2 | 0.07% | $ 2 | 0. |
| Real estate-construction | 99 | 2.86% | 115 | 5.03% | 65 | 3. |
| Real estate-residential | 321 | 9.26% | 266 | 9.55% | 240 | 9. |
| Real estate-multi-family | 169 | 5.60% | 103 | 4.75% | 71 | 4. |
| Real estate-commercial | 2,492 | 68.66% | 2,338 | 65.94% | 1,795 | 68. |
| Commercial | 1,041 | 13.27% | 982 | 14.31% | 730 | 13. |
| Consumer | 10 | 0.29% | 11 | 0.35% | 12 | 0. |
| Unallocated | - | - | - | - | 602 | |
| Total | $4,133 | 100.00% | $3,817 | 100.00% | $3,517 | 100. |

At September 30, 2002, the allowance for loan losses totaled $4,133,000 or 1.15% of total loans compared to 1.21% and 1.21% at December 31, 2001 and September 30, 2001, respectively. We charged $454,000 in loan losses against the allowance for loan losses during the nine months ended September 30, 2002. $450,000 of total 2002 loan losses related to one borrower.

The following table sets forth the activity in the allowance for loan losses and certain key ratios for the periods indicated. The bank's loan portfolio is relatively immature given its recent growth rates. Therefore, current charge-off and non-performing asset trends may not be indicative of future performance.

ALLOWANCE FOR LOAN LOSSES

| | FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2002 | FOR THE YEAR ENDED DECEMBER 31, 2001 | FO MO SEPTE |
|---|---|---|---|
| | | (Dollars in thousands) | |
| Balance at beginning of period | $ 3,817 | $ 3,032 | |
| Charge-offs | | | |
| Real estate-commercial | 295 | 29 | |
| Commercial | 159 | 4 | |
| Total charge-offs | 454 | 33 | |
| Recoveries | - | - | |
| Net charge-offs | 454 | 33 | |
| Provision for loan losses | 770 | 818 | |
| Balance at end of period | $ 4,133 | $ 3,817 | |
| Total gross loans: | | | |
| Average | $344,146 | $271,318 | |
| End of period | $359,644 | $316,066 | |
| Ratios: | | | |
| Net charge-offs to: | | | |
| Average loans | 0.13% | 0.01% | |
| Loans at end of period | 0.13% | 0.01% | |
| Allowance for loan losses | 10.98% | 0.86% | |
| Provision for loan losses | 58.96% | 4.03% | |
| Allowance for loan losses to: | | | |
| Total gross loans at end of period | 1.15% | 1.21% | |
| Non-performing loans | 80.68% | 142.05% | |

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(1) N/M stands for "not meaningful". There were no non-performing loans at September 30, 2001.



Non-performing assets

Non-performing assets are defined as accruing loans past due 90 days or more, non-accruing loans, restructured loans and other real estate owned. Non-performing assets represented .85% and .70% of total assets at September 30, 2002 and December 31, 2001, respectively.

NON-PERFORMING ASSETS

| | SEPTEMBER 30, 2002 | DECEMBER 31, 2001 |
|---|---|---|
| | (Dollars in thousands) | |
| Loans past due 90 days or more and accruing | $ - | $ - |
| Non-accrual loans | 5,123 | 2,687 |
| Other real estate owned | - | 475 |
| Total non-performing assets | $5,123 | $3,162 |
| Ratio of non-performing loans to total loans | 1.42% | 0.85% |
| Ratio of non-performing assets to total assets | 0.85% | 0.70% |

During the third quarter of 2002 we placed a total of $2,710,000 in loans on non-accrual and reversed a total of $84,000 in interest income. The non-accrual/impaired loan balance was substantially comprised of two borrowers with loans totaling $2,510,000 and $1,535,000 at September 30, 2002. At December 31, 2001 the non-accrual loan balance was substantially comprised of one borrower with loans totaling $2,330,000. After a $450,000 charge-off in the third quarter of 2002 and $345,000 in payments, this borrower remains on non-accrual with a balance of $1,535,000 at September 30, 2002. During the third quarter of 2002 we placed a $2,510,000 relationship on non-accrual and reversed $61,000 in interest income related to it. This $2,510,000 relationship is collateralized by three pieces of real estate.

The average balance of non-accrual/impaired loans was $3,610,000 for the three months ended September 30, 2002. There was $1,000 and $0 interest income recognized on non-accrual/impaired loans during the three months ended September 30, 2002 and 2001, respectively. Total interest income that would have been recognized on non-accrual loans was $140,000 and $0 for the three months ended September 30, 2002 and 2001, respectively.

The average balance of non-accrual loans was $2,876,000 for the nine months ended September 30, 2002. There was $5,000 and $0 in interest income recognized on non-accrual/impaired loans during the nine months ended September 30, 2002 and 2001, respectively. Total interest income that would have been recognized on non-accrual loans was $255,000 and $0 for the nine months ended September 30, 2002 and 2001, respectively.

Other real estate owned at December 31, 2001 was sold at a gain of $33,000 in May 2002.

Loans held for sale

The balance of loans held for sale was $1,508,000 at September 30, 2002 compared to $127,000 at December 31, 2001. The increase in loans held for sale relates to the timing of residential mortgage loan originations versus their sale.

We sold $6,133,000 and $5,572,000 of residential mortgages during the nine months ended September 30, 2002 and 2001, respectively. Residential mortgage originations and sales are significantly influenced by the interest rate environment.

Deferred taxes

Deferred taxes decreased $949,000 from $2,887,000 at December 31, 2001 to $1,938,000 at September 30, 2002. This decrease relates to the change in the estimated fair value of investment securities available for sale.

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Other assets

The $817,000 increase in other assets from $712,000 at December 31, 2001 to $1,529,000 at September 30, 2002 was primarily due to the deferral of $413,000 in costs related to our September issuance of $15,000,000 of trust preferred securities. These costs will be amortized over the life of the securities and reported as "Minority interest in expense of subsidiary." The remaining increase relates to increases in the principal due on delay-payment type mortgage-backed securities and in normal prepaid operating expenses.

Deposits

We are largely dependent upon our base of competitively priced core deposits to provide a stable source of funding. The bank has retained and grown its customer base since inception through a combination of price, quality service, customer confidence, convenience, a stable and experienced staff and through expansion of our network of offices. Core deposits, which exclude time deposits of $100,000 and greater, grew $75,413,000 or 25% during the nine months ended September 30, 2002 to $379,693,000. This growth was primarily generated by the Golden Checking product, which is an interest-bearing checking account. Through September 30, 2002, the bank maintained the rate payable on this account at an annual percentage yield of 3.05% despite the falling rate environment. As prevailing interest rates declined, Golden Checking accounts increased $73,732,000 during the nine months ended September 30, 2002 and the bank's deposit mix, although still concentrated in time deposits, shifted significantly toward non-maturity interest checking products. Interest checking accounts at September 30, 2002 were $145,373,000 or 33% of total deposits compared to $58,826,000 or 16% of total deposits at December 31, 2001. Total time deposits at September 30, 2002 were $187,911,000 or 43% of total deposits compared to $208,057,000 or 58% of total deposits at December 31, 2001. Approximately $94,492,000 of time deposits will mature after one year.

Total deposits increased $76,065,000 or 21% during the nine months ended September 30, 2002 to $434,347,000. Total average deposits increased $82,953,000 or 26% from $314,694,000 for the nine months ended September 30, 2001 to $397,647,000 for the nine months ended September 30, 2002. Non-interest-bearing deposits are an important source of funds for a bank because they lower overall deposit costs. The average balance of these accounts increased $4,599,000 or 18% during the nine months ended September 30, 2002 compared to the same period in 2001. The interest rates offered on most deposit products were lowered in 2001 and through the first half of 2002 in response to overall market conditions. Management expects the certificate of deposit portfolio to continue to reprice lower in 2002, as higher rate accounts mature and reprice in the lower rate environment.

The growth of mutual funds over the past decade has made it increasingly difficult for financial institutions to attract deposits. The continued flow of cash into mutual funds, much of which is made through tax deferred investment vehicles such as 401(k) plans, as well as a generally strong economy, have, until recently, fueled high returns for these investments, and in particular, certain equity funds. During 2001 and, continuing to date, the returns of the domestic equity markets were weak and volatile as the U.S. economy was generally sluggish. These conditions improved the environment for deposit acquisition for financial institutions as investors sought the relative safety of FDIC insured deposits, despite a low interest rate environment.

We plan to continue to grow deposits through promotions, business development programs, maturation of existing branches and branch expansion. In addition, Premier Bank introduced the IPCD product in the first quarter of 2001. The IPCD product contains an embedded derivative feature that provides a potential return to the depositor based on a formula that is dependent on the return of the Standard & Poor's 500(R) Index. This innovative deposit product allows a customer to receive a return that is based on an equity market index in place of a stated interest rate but, like other traditional certificates of deposit, is insured by the FDIC to the extent provided by law. As of September 30, 2002, the bank generated $16,518,000 in IPCD deposits with an initial term of five years. Approximately $13,145,000 of IPCD balances at September 30, 2002 was from institutional depositors. These depositors generally require us to obtain letters of credit guaranteeing the principal amounts of IPCD's in excess of FDIC insured levels. As of September 30, 2002, Premier Bank maintained $11,300,000 in letters of credit from the FHLB for this purpose. The amount of IPCD product, net of embedded derivatives, included in total deposits in the Consolidated Balance Sheet at September 30, 2002 was $13,966,000. See the section entitled "Derivative Financial Instruments."



DEPOSITS BY MAJOR CLASSIFICATION

| | SEPTEMBER 30, 2002 | | | DECEMBER 31, 2001 | | |
|---|---|---|---|---|---|---|
| | WEIGHTED AVERAGE INTEREST RATE | AMOUNT | % OF TOTAL | WEIGHTED AVERAGE INTEREST RATE | AMOUNT | % OF TOTAL |
| | | | (Dollars in thousands) | | | |
| Interest checking | 2.57% | $145,373 | 33.47% | 2.69% | $ 58,826 | 16.42% |
| Money market | 2.27% | 17,391 | 4.01% | 2.32% | 16,997 | 4.74% |
| Savings | 2.24% | 51,131 | 11.77% | 2.25% | 44,059 | 12.30% |
| Time | 3.86% | 187,911 | 43.26% | 5.31% | 208,057 | 58.07% |
| Total interest-bearing deposits | 3.12% | 401,806 | 92.51% | 4.27% | 327,939 | 91.53% |
| Non interest-bearing deposits | | 32,541 | 7.49% | | 30,343 | 8.47% |
| Total deposits | | $434,347 | 100.00% | | $358,282 | 100.00% |

Borrowings

Borrowings totaled $89,035,000 at September 30, 2002 compared to $49,605,000 at December 31, 2001.

Included in borrowings are customer repurchase agreements of $29,035,000 and $19,605,000 at September 30, 2002 and December 31, 2001, respectively. The balance in customer repurchase agreements fluctuates daily because it is dependent on the level of available funds in depositor accounts. Customer repurchase agreements are collateralized by investment securities in an amount equal to or exceeding such borrowings. The bank controls these pledged securities.

Borrowings also included $60,000,000 and $30,000,000 in long-term advances from the FHLB at September 30, 2002 and December 31, 2001, respectively. New long-term borrowings for the third quarter of 2002 included two $15,000,000 fixed rate 10-year advances from the FHLB. These advances may convert to a variable rate if the LIBOR index hits 7% and 8%, respectively. The bank has the option to prepay these advances if they convert to a variable rate.

The weighted average interest rate on borrowings was 3.45% and 3.83% at September 30, 2002 and December 31, 2001, respectively.

Other liabilities

Other liabilities increased $3,495,000 from $5,019,000 at December 31, 2001 to $8,514,000 at September 30, 2002. This increase relates principally to $3,883,000 in accrued investment purchases, and a $689,000 increase in the balance of derivatives related to our IPCD product. These increases were partially offset by an $807,000 decrease in federal income taxes payable and a $270,000 decrease in normal operating accounts.

CAPITAL ADEQUACY

Capital is fundamental to support our continued growth. In addition, PBI and Premier Bank are subject to various regulatory capital requirements. Regulatory capital is defined in terms of Tier 1 capital (shareholders' equity plus the allowable portion of the minority interest in equity of subsidiaries, minus unrealized gains or plus unrealized losses on available for sale securities, and minus certain intangible assets), Tier 2 capital (which includes a portion of the allowance for loan losses, minority interest in equity of subsidiaries and subordinated debt), and total capital (Tier 1 plus Tier 2). Risk-based capital ratios are expressed as a percentage of risk-weighted assets. Risk-weighted assets are determined by assigning various weights to all assets and off-balance sheet financial instruments, such as letters of credit and loan commitments, based on associated risk. Regulators have also adopted minimum Tier 1 leverage ratio standards, which measure the ratio of Tier 1 capital to total average quarterly assets.



Since year-end 2001, we completed two capital raising initiatives, which together generated $27,345,000. With the addition of this new capital we believe that we are well positioned to sustain the growth of our core business and to take advantage of diversification and expansion opportunities as they surface.

On September 26, 2002, we issued $15,000,000 of variable rate capital securities due November 30, 2032 through our Delaware subsidiary, Premier Capital Trust II. Interest on the capital securities is based on the 90-day LIBOR index plus 345 basis points. Proceeds from the capital securities provide PBI with Tier 1 and Tier 2 capital as determined by regulatory capital guidelines. See Footnote #9 entitled "Capital Securities".

On June 19, 2002, we completed our public offering of 552,000 shares of Series A 9.25% Non-Cumulative Perpetual Preferred Stock at $25.00 per share. The net proceeds from this offering totaled $12,345,000. The Series A Preferred stock qualifies as Tier 1 capital. Annual dividends on the Series A Preferred stock are $2.3125 per share or $1,276,500. Dividends are payable quarterly, but only if declared by our board of directors.

On July 11, 2002 our board of directors approved a cash dividend of $0.2698 per share to preferred shareholders of record on July 16, 2002. This dividend, totaling $149,000, was paid on July 31, 2002 and represented payment for the period from June 19, 2002 to July 30, 2002, the amount of time the shares of Series A Preferred Stock were outstanding for the quarter.

On October 7, 2002, PBI's board of directors approved a cash dividend of $0.578125 per share or $319,000 to preferred shareholders of record on October 16, 2002. This dividend was paid on October 31, 2002 and represented payment for the quarter August 1, 2002 through October 31, 2002.

On July 11, 2002, our board of directors approved a plan to purchase up to 4.9% of our outstanding common stock in the open market or in privately negotiated transactions. On October 22, 2002 our board of directors announced the termination of its stock repurchase program after the repurchase of 109,858 shares during the third quarter of 2002.

On October 11, 2002, PBI repaid $2,000,000 in variable rate subordinated debt which was included as Tier 2 capital at September 30, 2002.

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The tables below depict our capital components and ratios along with the "adequately" and "well" capitalized criteria as defined by FDIC regulations.

CAPITAL COMPONENTS

| | SEPTEMBER 30, 2002 | DE |
|---|---|---|
| | (Dollars in tho | |
| Tier 1 | | |
| Shareholders' equity | $ 36,064 | |
| Allowable portion of minority interest in equity of subsidiaries | 10,000 | |
| Net unrealized losses on investment securities available for sale | 1,160 | |
| Total Tier 1 Capital | $ 47,224 | |
| Tier 2 | | |
| Allowable portion of minority interest in equity of subsidiaries | $ 15,000 | |
| Allowable portion of the allowance for loan losses | 4,133 | |
| Allowable portion of subordinated debt | 3,500 | |
| Total Tier 2 Capital | $ 22,633 | |
| Total Capital | $ 69,857 | |
| Risk-weighted assets | $448,219 | |

CAPITAL RATIOS

| | SEPTEMBER 30, 2002 | DECEMBER 31, 2001 |
|---|---|---|
| Total risk-based capital/risk-weighted assets | 15.59% | 10.62% |
| Tier 1 capital/risk-weighted assets | 10.54% | 8.02% |
| Tier 1 capital/average assets (leverage ratio) | 8.68% | 6.83% |

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INTEREST RATE SENSITIVITY

We are subject to the interest rate risk inherent in our lending, investing and financing activities. Fluctuations in interest rates will impact both the interest income/expense and market value of all interest-earning assets and interest-bearing liabilities, other than those with a short term to maturity.

The primary objective in managing interest rate risk is to minimize the adverse impact of changes in interest rates on our net interest income while creating an asset/liability structure that maximizes earnings. The Asset Liability Management Committee actively monitors and manages our interest rate exposure using gap analysis and simulation models. Simulation models require significant assumptions about future business trends and interest rates.

Gap analysis measures the difference between volumes of interest rate-sensitive assets and liabilities and quantifies these repricing differences for various time intervals. Static gap analysis depicts interest sensitivity at a point in time. However, it alone does not accurately measure the magnitude of changes in net interest income because changes in interest rates do not always impact assets and liabilities at the same time or in the same magnitude. Furthermore, gap analysis does not consider future growth, changes in asset and liability composition or market conditions.

A positive gap results when the amount of interest rate-sensitive assets exceeds interest rate-sensitive liabilities repricing within the relevant time period and, generally means that the institution will benefit during periods of rising interest rates. A negative gap results when the amount of interest rate-sensitive liabilities exceeds interest rate-sensitive assets repricing within the relevant time period and, generally means that the institution will benefit during periods of falling interest rates. As depicted in the table below, we have a cumulative positive gap within the one-year time interval.

| SEPTEMBER 30, 2002 | WITHIN 3 MONTHS | 4 TO 6 MONTHS | 7 MONTHS TO 1 YEAR | 1 TO 3 YEARS | 3 TO 5 YEARS |
|---|---|---|---|---|---|
| | | | (DOLLARS IN THOUSANDS) | | |
| ASSETS | | | | | |
| Short-term investments | $ 33,817 | $ - | $ - | $ - | $ - |
| Interest-bearing deposits | 9,337 | - | - | - | - |
| Investment securities | 65,436 | 2,337 | 3,398 | 15,783 | 7,958 |
| Loans, net of deferred fees | 61,698 | 12,890 | 26,647 | 104,290 | 143,964 |
| Total interest rate-sensitive assets | $170,288 | $ 15,227 | $ 30,045 | $120,073 | $151,922 |
| Total cumulative assets | $170,288 | $185,515 | $215,560 | $335,633 | $487,555 |

| | | | | | |
|---|---|---|---|---|---|
| LIABILITIES | | | | | |
| Interest checking, money market and savings accounts | $ 8,556 | $ 6,417 | $ 12,834 | $128,117 | $ 42,779 |
| Time deposits | 30,786 | 22,819 | 39,816 | 62,533 | 31,957 |
| Short-term borrowings | 29,035 | - | - | - | - |
| Long-term borrowings | - | - | - | - | - |
| Subordinated debt | 2,000 | 1,500 | - | - | - |
| Total interest rate-sensitive liabilities | $ 70,377 | $ 30,736 | $ 52,650 | $190,650 | $ 74,736 |
| Total cumulative liabilities | $ 70,377 | $101,113 | $153,763 | $344,4 | |