

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549**

**FORM 10-K**

(Mark One)

**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934  
For the Fiscal Year Ended December 31, 2012**

OR

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

Commission file number: 001-33033

**PORTER BANCORP, INC.**  
(Exact name of registrant as specified in its charter)

Kentucky  
(State or other jurisdiction of  
incorporation or organization)

61-1142247  
(I.R.S. Employer Identification No.)

2500 Eastpoint Parkway, Louisville, Kentucky  
(Address of principal executive offices)

40223  
(Zip Code)

Registrant's telephone number, including area code: (502) 499-4800  
Securities registered pursuant to Section 12(b) of the Act:

Title of each class  
Common Stock, no par value

Name of each exchange on which registered  
NASDAQ Global Market

Securities registered pursuant to Section 12(g) of the Act:  
None

Indicate by check mark if the registrant is a well-known seasoned issuer (as defined in Rule 405 of the Securities Act). Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes  No

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 shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

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

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

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

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company

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

The aggregate market value of the voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold as of the close of business on June 30, 2012, was \$8,654,366 based upon the last sales price reported for such date on the NASDAQ Global Market.

The number of shares outstanding of the registrant's Common Stock, no par value, as of January 31, 2013, was 12,144,989.

#### DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's Proxy Statement for the Annual Meeting of Shareholders to be held May 22, 2013 are incorporated by reference into Part III of this Form 10-K.

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## PART I

### Preliminary Note Concerning Forward-Looking Statements

This report contains statements about the future expectations, activities and events that constitute forward-looking statements. Forward-looking statements express our beliefs, assumptions and expectations of our future financial and operating performance and growth plans, taking into account information currently available to us. These statements are not statements of historical fact. The words “believe,” “may,” “should,” “anticipate,” “estimate,” “expect,” “intend,” “objective,” “seek,” “plan,” “strive” or similar words, or the negatives of these words, identify forward-looking statements.

Forward-looking statements involve risks and uncertainties that may cause our actual results to differ materially from the expectations of future results we expressed or implied in any forward-looking statements. These risks and uncertainties can be difficult to predict and may be out of our control. Factors that could contribute to differences in our results include, but are not limited to deterioration in the financial condition of borrowers resulting in significant increases in loan losses and provisions for those losses; changes in the interest rate environment, which may reduce our margins or impact the value of securities, loans, deposits and other financial instruments; changes in loan underwriting, credit review or loss reserve policies associated with economic conditions, examination conclusions, or regulatory developments; general economic or business conditions, either nationally, regionally or locally in the communities we serve, may be worse than expected, resulting in, among other things, a deterioration in credit quality or a reduced demand for credit; the results of regulatory examinations; any matter that would cause us to conclude that there was impairment of any asset, including intangible assets; the continued service of key management personnel; our ability to attract, motivate and retain qualified employees; factors that increase the competitive pressure among depository and other financial institutions, including product and pricing pressures; the ability of our competitors with greater financial resources to develop and introduce products and services that enable them to compete more successfully than us; the impact of governmental restrictions on entities participating in the Capital Purchase Program of the U.S. Department of the Treasury; inability to comply with regulatory capital requirements and to secure any required regulatory approvals for capital actions; legislative or regulatory developments, including changes in laws concerning taxes, banking, securities, insurance and other aspects of the financial services industry; and fiscal and governmental policies of the United States federal government.

Other risks are detailed in Item 1A. “Risk Factors” of this Form 10-K all of which are difficult to predict and many of which are beyond our control.

Forward-looking statements are not guarantees of performance or results. A forward-looking statement may include the assumptions or bases underlying the forward-looking statement. We have made our assumptions and bases in good faith and believe they are reasonable. We caution you however, that estimates based on such assumptions or bases frequently differ from actual results, and the differences can be material. The forward-looking statements included in this report speak only as of the date of the report. We do not intend to update these statements unless applicable laws require us to do so.

### Item 1. Business

#### Overview

We are a bank holding company headquartered in Louisville, Kentucky. We are the eighth largest independent banking organization domiciled in the state of Kentucky based on total assets. Through our wholly-owned subsidiary PBI Bank, we operate 18 full-service banking offices in twelve counties in Kentucky. Our markets include metropolitan Louisville in Jefferson County and the surrounding counties of Henry and Bullitt, and extend south along the Interstate 65 corridor to Tennessee. We serve south central Kentucky and southern Kentucky from banking offices in Butler, Green, Hart, Edmonson, Barren, Warren, Ohio, and Daviess Counties. We also have an office in Lexington, the second largest city in Kentucky. PBI Bank is both a traditional community bank with a wide range of commercial and personal banking products, including wealth management and trust services, and an on-line bank which delivers competitive deposit products and services through an on-line banking division operating under the name of Ascencia. As of December 31, 2012, we had total assets of \$1.2 billion, total loans of \$899.1 million, total deposits of \$1.1 billion and stockholders’ equity of \$47.2 million.

#### History

We were organized in 1988, and historically conducted our banking business through separate community banks under the common control of J. Chester Porter, our chairman emeritus, and Maria L. Bouvette, our chairman and chief executive officer. In 2005, we completed a reorganization in which we consolidated our subsidiary banks into a single bank. On December 31, 2005, we renamed our consolidated subsidiary PBI Bank to create a single brand name for our banking operations throughout our market area. We completed our initial public offering in September 2006.

On November 21, 2008, we issued to the U.S. Treasury, in exchange for cash consideration of \$35.0 million, (i) 35,000 shares of Fixed Rate Cumulative Perpetual Preferred Stock, Series A, with a liquidation preference of \$1,000 per share (the “Series A Preferred Stock”), and (ii) a warrant to purchase up to 330,561 shares of our common stock for \$15.88 per share.

In 2010, we completed a \$32.0 million private placement to accredited investors. Following completion of the transactions involved, Porter Bancorp had issued (i) 2,465,569 shares of common stock, (ii) 317,042 shares of Non-Voting Cumulative Mandatorily Convertible Perpetual Preferred Shares, Series C (“Series C Preferred Stock”) and (iii) warrants to purchase 1,163,045 shares of non-voting common stock at a price of \$11.50 per share. See Item 7., Management’s Discussion and Analysis of Financial Condition and Results of Operation – Capital.

On June 24, 2011, PBI Bank entered into a consent order with the Federal Deposit Insurance Corporation (“FDIC”) and the Kentucky Department of Financial Institutions (“KDFI”). The consent order requires the Bank to improve its asset quality, reduce its loan concentrations, and maintain a minimum Tier 1 leverage ratio of 9% and a minimum total risk based capital ratio of 12%.

On September 21, 2011, Porter Bancorp entered into a written agreement with the Federal Reserve Bank of St. Louis. Porter Bancorp made formal commitments to use its resources to serve as a source of strength for PBI Bank, to assist the Bank in addressing weaknesses identified by the FDIC and the KDFI, to pay no dividends without prior written approval, to pay no interest on subordinated debentures or principal on trust preferred securities without written approval, and to submit a plan to maintain sufficient capital.

In October 2012, the Bank entered into a new Consent Order with the FDIC and KDFI again agreeing to maintain a minimum Tier 1 leverage ratio of 9% and a minimum total risk based capital ratio of 12%. The Bank also agreed that if it should be unable to reach the required capital levels, and if directed in writing by the FDIC, then the Bank would within 30 days develop, adopt and implement a written plan to sell or merge itself into another federally insured financial institution or otherwise immediately obtain a sufficient capital investment into the Bank to fully meet the capital requirements. The new Consent Order also requires the Bank to continue to adhere to the plans implemented in response to the June 2011 Consent Order, and includes the substantive provisions of the June 2011 Consent Order.

## Our Markets

We operate in markets that include the four largest cities in Kentucky – Louisville, Lexington, Owensboro and Bowling Green – and in other communities along the I-65 corridor.

- **Louisville/Jefferson, Bullitt and Henry Counties:** Our headquarters are in Louisville, the largest city in Kentucky and the twenty-seventh largest city in the United States. The Louisville metropolitan area includes the consolidated Louisville/Jefferson County and 12 surrounding Kentucky and Southern Indiana counties with an estimated 1.3 million residents in 2011. We also have banking offices in Bullitt County, south of Louisville, and Henry County, east of Louisville. Our six banking offices in these counties also serve the contiguous counties of Spencer, Shelby and Oldham to the east and northeast of Louisville. The area’s employers are diversified across many industries and include the air hub for United Parcel Service (“UPS”), two Ford assembly plants, General Electric’s Consumer and Industrial division, Humana, Norton Healthcare, Brown-Forman and YUM! Brands.
- **Lexington/Fayette County:** Lexington, located in Fayette County, is the second largest city in Kentucky with an estimated countywide population of over 302,000 in 2011. Lexington is the financial, educational, retail, healthcare and cultural hub for Central and Eastern Kentucky. It is known worldwide for its Bluegrass horse farms and Keeneland Race Track, and proudly boasts of itself as “The Horse Capital of the World.” It is also the home of the University of Kentucky and Transylvania University. The area’s employers include Toyota, Lexmark, IBM Global Services and Valvoline.
- **Southern Kentucky:** This market includes Bowling Green, the third largest city in Kentucky, located about 60 miles north of Nashville, Tennessee. Bowling Green, located in Warren County, is the home of Western Kentucky University and is the economic hub of the area. This market also includes thriving communities in the contiguous Barren County, including the city of Glasgow. The combined population of Warren and Barren counties was approximately 158,000 in 2011. Major employers in Barren and Warren Counties include GM’s Corvette plant and several other automotive facilities and R.R. Donnelley’s regional printing facility.
- **Owensboro/Daviess County:** Owensboro, located on the banks of the Ohio River, is Kentucky’s fourth largest city. Daviess County had an estimated countywide population of approximately 97,000 in 2011. The city is called a festival city, with over 20 annual community celebrations that attract visitors from around the world, including its world famous Bar-B-Q Festival which attracts over 80,000 visitors giving Owensboro recognition as “The Bar-B-Q Capital of the World”. It is an industrial, medical, retail and cultural hub for Western Kentucky and the area employers include Owensboro Medical System, Texas Gas, US Bank Home Mortgage and Toyotetsu.

- **South Central Kentucky:** South of the Louisville metropolitan area, we have banking offices in Butler, Edmonson, Green, Hart, and Ohio Counties, which had a combined population of approximately 78,000 in 2011. This region includes stable community markets comprised primarily of agricultural and service-based businesses. Each of our banking offices in these markets has a stable customer and core deposit base.

## **Our Products and Services**

We meet our customers' banking needs with a broad range of financial products and services. Our lending services include real estate, commercial, mortgage and consumer loans to small to medium-sized businesses, the owners and employees of those businesses, and other executives and professionals. We complement our lending operations with an array of retail and commercial deposit products. In addition, we offer our customers drive-through banking facilities, automatic teller machines, night depository, personalized checks, credit cards, debit cards, internet banking, electronic funds transfers through ACH services, domestic and foreign wire transfers, travelers' checks, cash management, vault services, loan and deposit sweep accounts and lock box services. Through our trust division, we offer personal trust services, employer retirement plan services and personal financial and retirement planning services.

## **Employees**

At December 31, 2012, the Company had 278 full-time equivalent employees. Our employees are not subject to a collective bargaining agreement, and management considers the Company's relationship with employees to be good.

## **Competition**

The banking business is highly competitive, and we experience competition in our market from many other financial institutions. Competition among financial institutions is based upon interest rates offered on deposit accounts, interest rates charged on loans, other credit and service charges relating to loans, the quality and scope of the services offered, the convenience of banking facilities and, in the case of loans to commercial borrowers, relative lending limits. We compete with commercial banks, credit unions, savings and loan associations, mortgage banking firms, consumer finance companies, securities brokerage firms, insurance companies, money market funds and other mutual funds, as well as super-regional, national and international financial institutions that operate offices within our market area and beyond.

There are a number of banks that offer services exclusively over the internet and other banks market their internet services to their customers nationwide. Many of the larger banks have greater market presence and greater financial resources to market their internet banking services. Additionally, new competitors and competitive factors are likely to emerge, particularly in view of the rapid development of internet commerce. On the other hand, we believe that many customers prefer to be able to conduct their banking transactions at local banking offices. We believe that these findings support our strategic decision to complement our traditional community bank with our uniquely branded online bank to offer customers the benefits of both traditional and internet banking services.

## **Supervision and Regulation**

**Consent Order and Formal Written Agreement.** On June 24, 2011, PBI Bank entered into a Consent Order with the FDIC and the Kentucky Department of Financial Institutions. PBI Bank agreed to obtain the written consent of both agencies before declaring or paying any future dividends. As a practical matter, PBI Bank will not be able to pay dividends to Porter Bancorp for the foreseeable future. The consent order also establishes benchmarks for the Bank to improve its asset quality, reduce its loan concentrations, and maintain a minimum Tier 1 leverage ratio of 9% and a minimum total risk based capital ratio of 12%. At December 31, 2012, the Bank's Tier 1 leverage ratio declined to 5.4% and its total risk-based capital ratio declined to 9.8%, which are below the minimums of 9.0% and 12.0% required by the Bank's Consent Order. At December 31, 2012, Porter Bancorp's leverage ratio was 4.5% and its total risk-based capital ratio was 9.8%. We are continuing our efforts to strengthen our capital levels and comply with the Consent Order as outlined in the written capital plan submitted by the Bank to its regulators in December 2012.

On September 21, 2011, we entered into a formal written agreement with the Federal Bank of St. Louis. Porter Bancorp made formal commitments in the agreement to use its financial and management resources to serve as a source of strength for the Bank and to assist the Bank in addressing weaknesses identified by the FDIC and the KDFI, to pay no dividends without prior written approval, to pay no interest or principal on subordinated debentures or trust preferred securities without written approval, and to submit an acceptable plan to maintain sufficient capital.

In October 2012, the Bank entered into a new Consent Order with the FDIC and KDFI again agreeing to maintain a minimum Tier 1 leverage ratio of 9% and a minimum total risk based capital ratio of 12%. The Bank also agreed that if it should be unable to reach the required capital levels, and if directed in writing by the FDIC, then the Bank would within 30 days develop, adopt and implement a written plan to sell or merge itself into another federally insured financial institution or otherwise obtain a capital investment into the Bank sufficient to fully meet the capital requirements.

We expect to continue to work with our regulators toward capital ratio compliance as outlined in the written capital plan previously submitted by the Bank. The new Consent Order also requires the Bank to continue to adhere to the plans implemented in response to the June 2011 Consent Order, and includes the substantive provisions of the June 2011 Consent Order. As of December 31, 2012, the capital ratios required by the Consent Order were not met.

**Bank and Holding Company Laws, Rules and Regulations.** The following is a summary description of the relevant laws, rules and regulations governing banks and bank holding companies. The descriptions of, and references to, the statutes and regulations below are brief summaries and do not purport to be complete. The descriptions are qualified in their entirety by reference to the specific statutes and regulations discussed.

**The Dodd-Frank Act.** On July 21, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank Act”) was signed into law. The Dodd-Frank Act imposes new restrictions and an expanded framework of regulatory oversight for financial institutions, including depository institutions. Because the Dodd-Frank Act requires various federal agencies to adopt a broad range of regulations with significant discretion, many of the details of the new law and the effects it will have on the Company are not known at this time.

The Dodd-Frank Act represents a comprehensive overhaul of the financial services industry within the United States. There are a number of reform provisions that are likely to significantly impact the ways in which banks and bank holding companies, including the Company, do business. For example, the Dodd-Frank Act changes the assessment base for federal deposit insurance premiums by modifying the deposit insurance assessment base calculation to be based on a depository institution’s consolidated assets less tangible capital instead of deposits, permanently increases the standard maximum amount of deposit insurance per customer to \$250,000 and extends the unlimited deposit insurance on non-interest bearing transaction accounts through January 1, 2013. The Dodd-Frank Act also imposes more stringent capital requirements on bank holding companies by, among other things, imposing leverage ratios on bank holding companies and prohibiting new trust preferred security issuances from counting as Tier I capital. The Dodd-Frank Act also repeals the federal prohibition on the payment of interest on demand deposits, thereby permitting depository institutions to pay interest on business transaction and other accounts. The Act codifies and expands the Federal Reserve’s source of strength doctrine, which requires that all bank holding companies serve as a source of financial strength for its subsidiary banks. Other provisions of the Dodd-Frank Act include, but are not limited to: (i) the creation of a new financial consumer protection agency that is empowered to promulgate new consumer protection regulations and revise existing regulations in many areas of consumer protection; (ii) enhanced regulation of financial markets, including derivatives and securitization markets; (iii) reform related to the regulation of credit rating agencies; (iv) the elimination of certain trading activities by banks; and (v) new disclosure and other requirements relating to executive compensation and corporate governance.

Many provisions of the Dodd-Frank Act will not be implemented immediately and will require interpretation and rule-making by federal agencies. The Company is monitoring all relevant sections of the Dodd-Frank Act to ensure continued compliance with laws and regulations. While the ultimate effect of the Dodd-Frank Act on the Company cannot currently be determined, the law is likely to result in increased compliance costs and fees paid to regulators, along with possible restrictions on the Company’s operations.

**Porter Bancorp.** Porter Bancorp is registered as a bank holding company under the Bank Holding Company Act of 1956, as amended, and is subject to supervision and regulation by the Board of Governors of the Federal Reserve System. As such, we must file with the Federal Reserve Board annual and quarterly reports and other information regarding our business operations and the business operations of our subsidiaries. We are also subject to examination by the Federal Reserve Board and to operational guidelines established by the Federal Reserve Board. We are subject to the Bank Holding Company Act and other federal laws on the types of activities in which we may engage, and to other supervisory requirements, including regulatory enforcement actions for violations of laws and regulations.

**Acquisitions.** A bank holding company must obtain Federal Reserve Board approval before acquiring, directly or indirectly, ownership or control of more than 5% of the voting stock or all or substantially all of the assets of a bank, merging or consolidating with any other bank holding company and before engaging, or acquiring a company that is not a bank but is engaged in certain non-banking activities. Federal law also prohibits a person or group of persons from acquiring “control” of a bank holding company without notifying the Federal Reserve Board in advance, and then only if the Federal Reserve Board does not object to the proposed transaction. The Federal Reserve Board has established a rebuttable presumptive standard that the acquisition of 10% or more of the voting stock of a bank holding company would constitute an acquisition of control of the bank holding company. In addition, any company is required to obtain the approval of the Federal Reserve Board before acquiring 25% (5% in the case of an acquirer that is a bank holding company) or more of any class of a bank holding company’s voting securities, or otherwise obtaining control or a “controlling influence” over a bank holding company.

*Permissible Activities.* A bank holding company is generally permitted under the Bank Holding Company Act to engage in or acquire direct or indirect control of more than 5% of the voting shares of any bank, bank holding company or company engaged in any activity that the Federal Reserve Board determines to be so closely related to banking as to be a proper incident to the business of banking.

Under current federal law, a bank holding company may elect to become a financial holding company, which enables the holding company to conduct activities that are “financial in nature.” Activities that are “financial in nature” include securities underwriting, dealing and market making; sponsoring mutual funds and investment companies; insurance underwriting and agency; merchant banking activities; and activities that the Federal Reserve Board has determined to be closely related to banking. No regulatory approval will be required for a financial holding company to acquire a company, other than a bank or savings association, engaged in activities that are financial in nature or incidental to activities that are financial in nature, as determined by the Federal Reserve Board. We have not filed an election to become a financial holding company.

*U.S. Treasury Capital Purchase Program .* On November 21, 2008, pursuant to the U.S. Department of the Treasury’s (the “U.S. Treasury”) Capital Purchase Program (the “CPP”), established under the Emergency Economic Stabilization Act of 2008 (“EESA”), Porter Bancorp issued and sold to the U.S. Treasury in an offering exempt from registration under the Securities Act of 1933, (i) 35,000 shares of Porter Bancorp’s Fixed Rate Cumulative Perpetual Preferred Stock, Series A, no par value and liquidation preference \$1,000 per share (\$35 million aggregate liquidation preference) (the “Series A Preferred Stock”) and (ii) a warrant (the “Warrant”) to purchase 330,561 shares (adjusted for stock dividends) of Porter Bancorp’s common stock, at an exercise price of \$15.88 per share (adjusted for stock dividends), subject to certain anti-dilution and other adjustments for an aggregate purchase price of \$35 million in cash. The securities purchase agreement, dated November 21, 2008, pursuant to which the securities issued to the U.S. Treasury under the CPP were sold, limits the payment of dividends on Porter Bancorp’s common stock to the quarterly dividend level at the time of the transaction without prior approval of the U.S. Treasury, limits Porter Bancorp’s ability to repurchase shares of its common stock (with certain exceptions, including the repurchase of our common stock to offset share dilution from equity-based compensation awards) and grants registration rights to the holders of the Series A Preferred Stock, the Warrant and the common stock of Porter Bancorp to be issued upon any exercise of the Warrant. The U.S. Treasury has notified us that it intends to sell at auction the shares of Series A Preferred Stock issued by the Company. We do not know, at this time, the U.S. Treasury’s timeline for such a sale.

The American Recovery and Reinvestment Act (“ARRA”) was enacted on February 17, 2009. ARRA imposes certain executive compensation and corporate governance obligations on all current and future CPP recipients, including Porter Bancorp, until the institution has redeemed the preferred stock. On June 15, 2009, under the authority granted to it under EESA and ARRA, the U. S. Treasury issued an interim final rule under Section 111 of EESA, as amended by ARRA, regarding compensation and corporate governance restrictions that would be imposed on CPP recipients, effective June 15, 2009. As a CPP recipient with currently outstanding CPP obligations, we are subject to the compensation and corporate governance restrictions and requirements set forth in the interim final rule. The restrictions and requirements provided for in the implementing regulations are generally as follows: (1) required us to establish an independent compensation committee, (2) required us to adopt a corporate policy on luxury or excessive expenditures; (3) requires our compensation committee to conduct semi-annual risk assessments to assure that our compensation arrangements do not encourage “unnecessary and excessive risks” or the manipulation of earnings to increase compensation; (4) requires us to recoup or “clawback” any bonus, retention award or incentive compensation paid by us to a senior executive officer or any of our next 20 most highly compensated employees, if the payment was based on financial statements or other performance criteria that are later found to be materially inaccurate; (5) prohibits us from making severance payments or “golden parachutes” to any of our senior executive officers or next five most highly compensated employees; (6) prohibits us from paying or accruing bonuses, retention awards or incentive compensation, except for certain long-term stock awards, to our five most highly compensated employees; (7) prohibits us from providing tax gross-ups to any of our senior executive officers or next 20 most highly compensated employees; (8) requires us to provide enhanced disclosure of perquisites to the FDIC and the U.S. Treasury; (9) requires us to disclose to the FDIC and the U.S. Treasury the use and role of compensation consultants; (10) requires our chief executive officer and chief financial officer to provide period certifications about our compensation practices and compliance with the interim final rule; and (11) requires us to provide an annual non-binding shareholder vote, or “say-on-pay” proposal, to approve the compensation of our named executives, consistent with regulations promulgated by the Securities and Exchange Commission. On January 12, 2010, the SEC adopted final regulations setting forth the parameters for such say-on pay proposals for public company CPP participants. The U.S. Treasury has notified us that it intends to sell at auction the shares of Series A Preferred Stock issued by the Company. We do not know the U.S. Treasury’s timeline for that sale. If the U.S. Treasury completes such a sale, most of the compensation restrictions described above will no longer apply to the Company and the Bank.



*Capital Adequacy Requirements.* The Federal Reserve Board has adopted a system using risk-based capital guidelines to evaluate the capital adequacy of bank holding companies. Under the guidelines, specific categories of assets are assigned different risk weights, based generally on the perceived credit risk of the asset. These risk weights are multiplied by corresponding asset balances to determine a “risk-weighted” asset base. The guidelines require a minimum total risk-based capital ratio of 8.0%. At least half of the total capital must be composed of common equity, retained earnings, senior perpetual preferred stock issued to the U. S. Treasury under the CPP and qualifying perpetual preferred stock and certain hybrid capital instruments, less certain intangible assets (“Tier 1 capital”). The remainder may consist of certain subordinated debt, certain hybrid capital instruments, qualifying preferred stock and a limited amount of the allowance for loan losses (“Tier 2 capital”). Total capital is the sum of Tier 1 and Tier 2 capital. To be considered well-capitalized under the risk-based capital guidelines, an institution must maintain a total capital to total risk-weighted assets ratio of at least 10% and a Tier 1 capital to total risk-weighted assets ratio of 6% or greater. We are under a Consent Order with our primary regulators as previously discussed. Please see “Supervision and Regulation” above for our capital requirements.

In addition to the risk-based capital guidelines, the Federal Reserve Board uses a leverage ratio as an additional tool to evaluate the capital adequacy of bank holding companies. The leverage ratio is a company’s Tier 1 capital divided by its average total consolidated assets. Certain highly rated bank holding companies may maintain a minimum leverage ratio of 3.0%, but other bank holding companies may be required to maintain a leverage ratio of 4.0%.

The federal banking agencies’ risk-based and leverage ratios are minimum supervisory ratios generally applicable to banking organizations that meet certain specified criteria, assuming that they have the highest regulatory rating. Banking organizations not meeting these criteria are expected to operate with capital positions well above the minimum ratios. The federal bank regulatory agencies may set capital requirements for a particular banking organization that are higher than the minimum ratios when circumstances warrant. Federal Reserve Board guidelines also provide that banking organizations experiencing internal growth or making acquisitions will be expected to maintain strong capital positions substantially above the minimum supervisory levels, without significant reliance on intangible assets.

*Dividends.* Under Federal Reserve policy, bank holding companies should pay cash dividends on common stock only out of income available over the past year and only if prospective earnings retention is consistent with the organization’s expected future needs and financial condition. The policy provides that bank holding companies should not declare a level of cash dividends that undermines the bank holding company’s ability to serve as a source of strength to its banking subsidiaries.

Porter Bancorp is a legal entity separate and distinct from PBI Bank. The majority of our revenue is from dividends paid to us by PBI Bank. PBI Bank is subject to laws and regulations that limit the amount of dividends it can pay. If, in the opinion of a federal regulatory agency, an institution under its jurisdiction is engaged in or is about to engage in an unsafe or unsound practice, the agency may require, after notice and hearing, that the institution cease such practice. The federal banking agencies have indicated that paying dividends that deplete an institution’s capital base to an inadequate level would be an unsafe and unsound banking practice. Under the Federal Deposit Insurance Corporation Improvement Act (FDICIA), an insured institution may not pay any dividend if payment would cause it to become undercapitalized or if it already is undercapitalized. Moreover, the Federal Reserve and the FDIC have issued policy statements providing that bank holding companies and banks should generally pay dividends only out of current operating earnings. A bank holding company may still declare and pay a dividend if it does not have current operating earnings if the bank holding company expects profits for the entire year and the bank holding company obtains the prior consent of the Federal Reserve. Porter Bancorp and PBI Bank must obtain the prior written consent of each of their primary regulators prior to declaring or paying any future dividends.

Under Kentucky law, dividends by Kentucky banks may be paid only from current or retained net profits. Before any dividend may be declared for any period (other than with respect to preferred stock), a bank must increase its capital surplus by at least 10% of the net profits of the bank for the period until the bank’s capital surplus equals the amount of its stated capital attributable to its common stock. Moreover, the Kentucky Department of Financial Institutions must approve the declaration of dividends if the total dividends to be declared by a bank for any calendar year would exceed the bank’s total net profits for such year combined with its retained net profits for the preceding two years, less any required transfers to surplus or a fund for the retirement of preferred stock or debt. We are also subject to the Kentucky Business Corporation Act, which generally prohibits dividends to the extent they result in the insolvency of the corporation from a balance sheet perspective or in the corporation becoming unable to pay its debts as they come due. PBI Bank did not pay any dividends in 2012.

Prior to November 21, 2011, unless Porter Bancorp redeemed all of the Series A Preferred Stock issued to the U.S. Treasury on November 21, 2008 or unless the U.S. Treasury transferred all the preferred securities to a third party, the consent of the U.S. Treasury was required for Porter Bancorp to declare or pay any dividend or make any distribution on common stock other than (i) regular quarterly cash dividends of not more than the per share dividend amount at the time of the issuance of the Series A Preferred Stock, as adjusted for any stock split, stock dividend, reverse stock split, reclassification or similar transaction, (ii) dividends payable solely in shares of common stock and (iii) dividends or distributions of rights or junior stock in connection with a shareholders’ rights plan.

*Imposition of Liability for Undercapitalized Subsidiaries.* Bank regulators are required to take “prompt corrective action” to resolve problems associated with insured depository institutions whose capital declines below certain levels. In the event an institution becomes “undercapitalized,” it must submit a capital restoration plan. The capital restoration plan will not be accepted by the regulators unless each company having control of the undercapitalized institution guarantees the subsidiary’s compliance with the capital restoration plan up to a certain specified amount. Any such guarantee from a depository institution’s holding company is entitled to a priority of payment in bankruptcy.

The aggregate liability of the holding company of an undercapitalized bank is limited to the lesser of 5% of the institution’s assets at the time it became undercapitalized or the amount necessary to cause the institution to be “adequately capitalized.” The bank regulators have greater power in situations where an institution becomes “significantly” or “critically” undercapitalized or fails to submit a capital restoration plan. For example, a bank holding company controlling such an institution can be required to obtain prior Federal Reserve Board approval of proposed dividends, or might be required to consent to a consolidation or to divest the troubled institution or other affiliates.

*Source of Financial Strength.* Under Federal Reserve policy, a bank holding company is expected to act as a source of financial strength to, and to commit resources to support, its bank subsidiaries. This support may be required at times when, absent such a policy, the bank holding company may not be inclined to provide it. In addition, any capital loans by the bank holding company to its bank subsidiaries are subordinate in right of payment to deposits and to certain other indebtedness of the bank subsidiary. In the event of a bank holding company’s bankruptcy, any commitment by the bank holding company to a federal bank regulatory agency to maintain the capital of subsidiary banks will be assumed by the bankruptcy trustee and entitled to a priority of payment. The Federal Reserve’s “Source of Financial Strength” policy was codified in the Dodd-Frank Act.

**PBI Bank.** PBI Bank, a Kentucky chartered commercial bank, is subject to regular bank examinations and other supervision and regulation by both the FDIC and the Kentucky Department of Financial Institutions (“KDFI”). Kentucky’s banking statutes contain a “super-parity” provision that permits a well-rated Kentucky banking corporation to engage in any banking activity which could be engaged in by a national bank operating in any state; a state bank, a thrift or savings bank operating in any other state; or a federal chartered thrift or federal savings association meeting the qualified thrift lender test and operating in any state could engage, provided the Kentucky bank first obtains a legal opinion specifying the statutory or regulatory provisions that permit the activity.

*Capital Requirements.* Similar to the Federal Reserve Board’s requirements for bank holding companies, the FDIC has adopted risk-based capital requirements for assessing state non-member banks’ capital adequacy. The FDIC’s risk-based capital guidelines require that all banks maintain a minimum ratio of total capital to total risk-weighted assets of 8.0% and a minimum ratio of Tier 1 capital to total risk-weighted assets of 4.0%. To be well-capitalized, a bank must have a ratio of total capital to total risk-weighted assets of at least 10.0% and a ratio of Tier 1 capital to total risk-weighted assets of 6.0%.

PBI Bank has agreed with its primary regulators to maintain a ratio of total capital to total risk-weighted assets of at least 12.0% and a ratio of Tier 1 capital to total assets of 9%. As of December 31, 2012, PBI Bank’s ratio of total capital to total risk-weighted assets was 9.8% and its ratio of Tier 1 capital to total assets was 5.4%, both under the ratios required by the Consent Order.

The FDIC also requires a minimum leverage ratio of 3.0% of Tier 1 capital to total assets for the highest rated banks and an additional cushion of approximately 100-200 basis points for all other banks. The leverage ratio operates in tandem with the FDIC’s risk-based capital guidelines and places a limit on the amount of leverage a bank can undertake by requiring a minimum level of capital to total assets.

*Prompt Corrective Action.* Pursuant to the Federal Deposit Insurance Act (“FDIA”), the FDIC must take prompt corrective action to resolve the problems of undercapitalized institutions. FDIC regulations define the levels at which an insured institution would be considered “well capitalized,” “adequately capitalized,” “undercapitalized,” “significantly undercapitalized” and “critically undercapitalized.” A “well-capitalized” bank has a total risk-based capital ratio of 10.0% or higher; a Tier 1 risk-based capital ratio of 6.0% or higher; a leverage ratio of 5.0% or higher; and is not subject to any written agreement, order or directive requiring it to maintain a specific capital level for any capital measure. An “adequately capitalized” bank has a total risk-based capital ratio of 8.0% or higher; a Tier 1 risk-based capital ratio of 4.0% or higher; a leverage ratio of 4.0% or higher (3.0% or higher if the bank was rated a composite 1 in its most recent examination report and is not experiencing significant growth); and does not meet the criteria for a well-capitalized bank. A bank is “undercapitalized” if it fails to meet any one of the ratios required to be adequately capitalized. A depository institution may be deemed to be in a capitalization category that is lower than is indicated by its actual capital position if it receives an unsatisfactory examination rating. The degree of regulatory scrutiny increases and the permissible activities of a bank decreases, as the bank moves downward through the capital categories. Depending on a bank’s level of capital, the FDIC’s corrective powers include:

- requiring a capital restoration plan;
- placing limits on asset growth and restriction on activities;
- requiring the bank to issue additional voting or other capital stock or to be acquired;
- placing restrictions on transactions with affiliates;
- restricting the interest rate the bank may pay on deposits;
- ordering a new election of the bank's board of directors;
- requiring that certain senior executive officers or directors be dismissed;
- prohibiting the bank from accepting deposits from correspondent banks;
- requiring the bank to divest certain subsidiaries;
- prohibiting the payment of principal or interest on subordinated debt; and
- ultimately, appointing a receiver for the bank.

In the event an institution is required to submit a capital restoration plan, the institution's holding company must guaranty the subsidiary's compliance with the capital restoration plan up to a certain specified amount. Any such guarantee from a depository institution's holding company is entitled to a priority of payment in bankruptcy. The aggregate liability of the holding company of an undercapitalized bank is limited to the lesser of 5% of the institution's assets at the time it became undercapitalized or the amount necessary to cause the institution to be "adequately capitalized." The bank regulators have greater power in situations where an institution becomes "significantly" or "critically" undercapitalized or fails to submit a capital restoration plan. For example, a bank holding company controlling such an institution can be required to obtain prior Federal Reserve Board approval of proposed dividends, or might be required to consent to a consolidation or to divest the troubled institution or other affiliates.

*Deposit Insurance Assessments.* The deposits of PBI Bank are insured by the Deposit Insurance Fund (DIF) of the FDIC up to the limits set forth under applicable law and are subject to the deposit insurance premium assessments of the DIF. The FDIC imposes a risk-based deposit premium assessment system, which was amended pursuant to the Federal Deposit Insurance Reform Act of 2005 (the "Reform Act"). Under this system, as amended, the assessment rates for an insured depository institution vary according to the level of risk incurred in its activities. To arrive at an assessment rate for a banking institution, the FDIC places it in one of four risk categories determined by reference to its capital levels and supervisory ratings. The assessment rate schedule can change from time to time, at the discretion of the FDIC, subject to certain limits.

On November 12, 2009, the FDIC amended the final rule adopted on May 22, 2009 to restore losses to the DIF. The new rule required insured institutions to prepay on December 30, 2009, an estimated quarterly risk-based assessment for the fourth quarter of 2009 and for all 2010, 2011, and 2012. An institution's assessment is calculated by taking the institution's actual September 30, 2009 assessment and adjusting it quarterly by an estimated 5% annual growth rate through the end of 2012. Further, the FDIC incorporated a uniform 3 basis point increase effective January 1, 2011. On December 30, 2009, PBI Bank prepaid \$7.9 million of FDIC insurance premiums for 2010 through 2012. The entire amount of the prepaid assessment was recorded as a prepaid expense. As of December 31, 2009, and each quarter thereafter, each institution is to record an expense, or a charge to earnings, for its quarterly assessment invoiced on its quarterly statement and an offsetting credit to the prepaid assessment until the asset is exhausted. At December 31, 2012, our prepaid assessment was exhausted.

The Dodd-Frank Act imposes additional assessments and costs with respect to deposits. Under the Dodd-Frank Act, the FDIC is directed to impose deposit insurance assessments based on total assets rather than total deposits, as well as making permanent the increase of deposit insurance to \$250,000 and providing for full insurance of non-interest bearing transaction accounts beginning December 31, 2010, for two years. In February 2011, the FDIC adopted a final rule on the deposit insurance assessment system. The rule is effective as of April 1, 2011, and revises the assessment system to comply with Dodd-Frank and also includes a revised assessment rate process with the goal of differentiating insured depository institutions who pose greater risk to the DIF. The first assessments under the new rule were payable in the third quarter of 2011.

*Safety and Soundness Standards.* The FDIA requires the federal bank regulatory agencies to prescribe standards, by regulations or guidelines, relating to internal controls, information systems and internal audit systems, loan documentation, credit underwriting, interest rate risk exposure, asset growth, asset quality, earnings, stock valuation and compensation, fees and benefits, and such other operational and managerial standards as the agencies deem appropriate. Guidelines adopted by the federal bank regulatory agencies establish general standards relating to internal controls and information systems, internal audit systems, loan documentation, credit underwriting, interest rate exposure, asset growth and compensation, fees and benefits. In general, the guidelines require, among other things, appropriate systems and practices to identify and manage the risk and exposures specified in the guidelines. The guidelines prohibit excessive compensation as an unsafe and unsound practice and describe compensation as excessive when the amounts paid are unreasonable or disproportionate to the services performed by an executive officer, employee, director or principal stockholder. In addition, the agencies adopted regulations that authorize, but do not require, an agency to order an institution that has been given notice by an agency that it is not satisfying any of such safety and

soundness standards to submit a compliance plan. If, after being so notified, an institution fails to submit an acceptable compliance plan or fails in any material respect to implement an acceptable compliance plan, the agency must issue an order directing action to correct the deficiency and may issue an order directing other actions of the types to which an undercapitalized institution is subject under the “prompt corrective action” provisions of FDIA. See “Prompt Corrective Actions” above. If an institution fails to comply with such an order, the agency may seek to enforce such order in judicial proceedings and to impose civil money penalties.

*Branching.* Kentucky law permits Kentucky chartered banks to establish a banking office in any county in Kentucky. A Kentucky bank may also establish a banking office outside of Kentucky. Well capitalized Kentucky banks that have been in operation at least three years and that satisfy certain criteria relating to, among other things, their composite and management ratings, may establish a banking office in Kentucky without the approval of the KDFI upon notice to the KDFI and any other state bank with its main office located in the county where the new banking office will be located. Branching by all other banks requires the approval of the KDFI, who must ascertain and determine that the public convenience and advantage will be served and promoted and that there is reasonable probability of the successful operation of the banking office.

The transaction must also be approved by the FDIC, which considers a number of factors, including financial history, capital adequacy, earnings prospects, character of management, needs of the community and consistency with corporate powers.

Historically, an out-of-state bank was permitted to establish banking offices in Kentucky only by merging with a Kentucky bank. De novo branching into Kentucky by an out-of-state bank was not permitted. This difficulty for out-of-state banks to branch in Kentucky limited the ability of a Kentucky bank to branch into many states, as several states have reciprocity requirements for interstate branching. The Dodd-Frank Act permits de novo interstate branching by national banks and insured state banks by amending the state “opt-in” election. Applications for out-of-state de novo branches would be approved if, under the law of the state in which the branch is to be located, a state bank chartered by such state would be permitted to establish the branch.

*Insider Credit Transactions.* The restrictions on loans to directors, executive officers, principal shareholders and their related interests (collectively referred to herein as “insiders”) contained in the Federal Reserve Act and Regulation O apply to all insured depository institutions and their subsidiaries. These restrictions include limits on loans to one borrower and conditions that must be met before such a loan can be made. There is also an aggregate limitation on all loans to insiders and their related interests. These loans cannot exceed the institution’s total unimpaired capital and surplus.

*Automated Overdraft Payment Regulation.* The Federal Reserve and FDIC have recently enacted consumer protection regulations related to automated overdraft payment programs offered by financial institutions. In November 2009, the Federal Reserve amended its Regulation E to prohibit financial institutions from charging consumers fees for paying overdrafts on automated teller machine and one-time debit card transactions, unless a consumer consents, or opts in, to the overdraft service for those types of transactions. The Regulation E amendments also require financial institutions to provide consumers with a notice that explains the financial institution’s overdraft services, including the fees associated with the service and the consumer’s choices.

In November 2010, the FDIC supplemented the Regulation E amendments by requiring FDIC-supervised institutions to implement additional changes relating to automated overdraft payment programs by July 1, 2011. The most significant of these changes require financial institutions to monitor overdraft payment programs for “excessive or chronic” customer use and undertake “meaningful and effective” follow-up action with customers that overdraw their accounts more than six times during a rolling 12-month period. The additional guidance also imposes daily limits on overdraft charges, requires institutions to review and modify check-clearing procedures, prominently distinguish account balances from available overdraft coverage amounts and requires increased board and management oversight regarding overdraft payment programs.

*Consumer Protection Laws.* PBI Bank is subject to consumer laws and regulations that are designed to protect consumers in transactions with banks. While the list set forth herein is not exhaustive, these laws and regulations include the Truth in Lending Act, the Truth in Savings Act, the Electronic Funds Transfer Act, the Expedited Funds Availability Act, the Equal Credit Opportunity Act, the Fair Housing Act, the Real Estate Settlement and Procedures Act, the Fair Credit Reporting Act, and the Federal Trade Commission Act, among others. References to or summaries of these laws is subject to the full text and implementation of such laws. These laws and regulations mandate certain disclosure requirements and regulate the manner in which financial institutions must deal with customers when taking deposits or making loans to such customers.

*Privacy.* Federal law currently contains extensive customer privacy protection provisions. Under these provisions, a financial institution must provide to its customers, at the inception of the customer relationship and annually thereafter, the institution's policies and procedures regarding the handling of customers' nonpublic personal financial information. These provisions also provide that, except for certain limited exceptions, an institution may not provide such personal information to unaffiliated third parties unless the institution discloses to the customer that such information may be so provided and the customer is given the opportunity to opt out of such disclosure. Federal law makes it a criminal offense, except in limited circumstances, to obtain or attempt to obtain customer information of a financial nature by fraudulent or deceptive means.

*Community Reinvestment Act.* The Community Reinvestment Act ("CRA") requires the FDIC to assess our record in meeting the credit needs of the communities we serve, including low- and moderate-income neighborhoods and persons. The FDIC's assessment of our record is made available to the public. The assessment also is part of the Federal Reserve Board's consideration of applications to acquire, merge or consolidate with another banking institution or its holding company, to establish a new banking office or to relocate an office.

*Bank Secrecy Act.* The Bank Secrecy Act of 1970 ("BSA") was enacted to deter money laundering, establish regulatory reporting standards for currency transactions and improve detection and investigation of criminal, tax and other regulatory violations. BSA and subsequent laws and regulations require us to take steps to prevent the use of PBI Bank in the flow of illegal or illicit money, including, without limitation, ensuring effective management oversight, establishing sound policies and procedures, developing effective monitoring and reporting capabilities, ensuring adequate training and establishing a comprehensive internal audit of BSA compliance activities. In recent years, federal regulators have increased the attention paid to compliance with the provisions of BSA and related laws, with particular attention paid to "Know Your Customer" practices. Banks have been encouraged by regulators to enhance their identification procedures prior to accepting new customers in order to deter criminal elements from using the banking system to move and hide illegal and illicit activities.

*USA Patriot Act.* The USA Patriot Act of 2001 (the "Patriot Act") contains anti-money laundering measures affecting insured depository institutions, broker-dealers and certain other financial institutions. The Patriot Act requires financial institutions to implement policies and procedures to combat money laundering and the financing of terrorism, including standards for verifying customer identification at account opening, and rules to promote cooperation among financial institutions, regulators and law enforcement entities in identifying parties that may be involved in terrorism or money laundering, and grants the Secretary of the Treasury broad authority to establish regulations and to impose requirements and restrictions on financial institutions' operations. In addition, the Patriot Act requires the federal bank regulatory agencies to consider the effectiveness of a financial institution's anti-money laundering activities when reviewing bank mergers and bank holding company acquisitions.

*Temporary Liquidity Guarantee Program.* Under the FDIC's Temporary Liquidity Guarantee Program (TLGP), the FDIC guaranteed U.S. depository institutions' transaction accounts and certain qualifying senior unsecured debt. We participated in the TLGP's Transaction Account Guarantee Program (TAGP), which provided that all non-interest bearing transaction accounts maintained at PBI Bank were insured in full by the FDIC, regardless of the standard maximum deposit insurance amounts. Although the guarantee of non-interest bearing transaction account deposits under the TLGP ended on June 30, 2010, the Dodd-Frank Act provided for unlimited FDIC deposit insurance coverage on non-interest bearing transaction accounts at all insured institutions, regardless of participation in the TLGP, until January 1, 2013.

**Effect on Economic Environment.** The policies of regulatory authorities, including the monetary policy of the Federal Reserve Board, have a significant effect on the operating results of bank holding companies and their subsidiaries. Among the means available to the Federal Reserve Board to affect the money supply are open market operations in U.S. government securities, changes in the discount rate on member bank borrowings and changes in reserve requirements against member bank deposits. These means are used in varying combinations to influence overall growth and distribution of bank loans, investments and deposits, and their use may affect interest rates charged on loans or paid for deposits.

Federal Reserve Board monetary policies have materially affected the operating results of commercial banks in the past and are expected to continue to do so in the future. The nature of future monetary policies and the effect of such policies on our business and earnings and those of our subsidiaries cannot be predicted.

**Recently Enacted and Future Legislation.** Various laws, regulations and governmental programs affecting financial institutions and the financial industry are from time to time introduced in Congress or otherwise promulgated by regulatory agencies. Such measures may change the operating environment of Porter Bancorp and its subsidiaries in substantial and unpredictable ways. The nature and extent of future legislative, regulatory or other changes affecting financial institutions is very unpredictable at this time.

We cannot predict what other legislation or economic policies of the various regulatory authorities might be enacted or adopted or what other regulations might be adopted or the effects thereof. Future legislation and policies and the effects thereof might have a significant influence on overall growth and distribution of loans, investments and deposits and affect interest rates charged on loans or paid on time and savings deposits. Such legislation and policies have had a significant effect on the operating results of commercial banks in the past and are expected to continue to do so in the future.

### **Available Information**

We file reports with the SEC including our annual report on Form 10-K, quarterly reports on Form 10-Q, current event reports on Form 8-K and proxy statements, as well as any amendments to those reports. The public may read and copy any materials we file with the SEC at the SEC's Public Reference Room at 100 F Street, NE, Washington, DC 20549. The public may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. The SEC maintains an internet site that contains reports, proxy and information statements and other information regarding issuers that file electronically with the SEC at <http://www.sec.gov>. Our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed or furnished pursuant to section 13(a) or 15(d) of the Exchange Act are accessible at no cost on our web site at <http://www.pbibank.com>, under the Investors Relations section, once they are electronically filed with or furnished to the SEC. A shareholder may also request a copy of our Annual Report on Form 10-K free of charge upon written request to: Chief Financial Officer, Porter Bancorp, Inc., 2500 Eastpoint Parkway, Louisville, Kentucky 40223.

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

An investment in our common stock involves a number of risks. Realization of any of the risks described below could have a material adverse effect on our business, financial condition, results of operations, cash flow and/or future prospects.

#### **We are subject to a Consent Order with the FDIC and the KDFI and a formal agreement with the Federal Reserve that restrict the conduct of our operations and may have a material adverse effect on our business.**

Our good standing with bank regulatory agencies is of fundamental importance to the continuation of our businesses. In June 2011, PBI Bank agreed to a Consent Order with the FDIC and KDFI in which the Bank agreed, among other things, to improve asset quality, reduce loan concentrations, and maintain a minimum Tier 1 leverage ratio of 9% and a minimum total risk based capital ratio of 12%. The Consent Order was included in our Current Report on 8-K filed on June 30, 2011.

On September 21, 2011, we entered into a Written Agreement with the Federal Reserve Bank of St. Louis. Pursuant to the Agreement, we made formal commitments to, among other things, use our financial and management resources to serve as a source of strength for the Bank and to assist the Bank in addressing weaknesses identified by the FDIC and the KDFI, to pay no dividends without prior written approval, to pay no interest or principal on subordinated debentures or trust preferred securities without prior written approval, and to submit an acceptable plan to maintain sufficient capital.

In October 2012, the Bank entered into a new Consent Order with the FDIC and KDFI again agreeing to maintain a minimum Tier 1 leverage ratio of 9% and a minimum total risk based capital ratio of 12%. The Bank also agreed that if it should be unable to reach the required capital levels, and if directed in writing by the FDIC, then the Bank would within 30 days develop, adopt and implement a written plan to sell or merge itself into another federally insured financial institution or otherwise immediately obtain a sufficient capital investment into the Bank to fully meet the capital requirements. The new Consent Order also requires the Bank to continue to adhere to the plans implemented in response to the June 2011 Consent Order, and includes the substantive provisions of the June 2011 Consent Order. We did not meet the capital ratios required by the Consent Order as of December 31, 2012.

Bank regulatory agencies can exercise discretion when an institution does not meet minimum regulatory capital levels and the other terms of a consent order. The agencies may initiate changes in management, issue mandatory directives, impose monetary penalties or refrain from formal sanctions, depending on individual circumstances. Any action taken by bank regulatory agencies could damage our reputation and have a material adverse effect on our business. Compliance with the Consent Order also increases our operating expense, and adversely affects our financial performance.

**We have made commitments to the banking regulators to raise additional capital. Our inability to increase our capital to the levels required by our bank regulatory agreements could have a material adverse effect on our business.**

We recorded a net loss to common shareholders of \$33.4 million in 2012. The net loss for 2012 was due in part to provision for loan losses of \$40.3 million, and \$10.5 million of expense related to other real estate owned.

Our losses, driven by asset impairments, nonperforming loan costs, and other real estate owned expenses, have reduced our capital below the levels agreed upon with our banking regulators. While we believe we have recognized the probable losses in our portfolio, the continuing weakness in the real estate market makes it difficult to determine the degree to which additional performing loans will deteriorate to weakened credit status. Further credit deterioration could result in additional losses and a reduction in capital levels.

In its consent order with the FDIC and the KDFI, PBI Bank has agreed to maintain a ratio of total capital to total risk-weighted assets of at least 12.0% and a ratio of Tier 1 capital to total assets of 9%. As of December 31, 2012, PBI Bank's ratio of total capital to total risk-weighted assets was 9.8% and its ratio of Tier 1 capital to total assets was 5.4%, both below the ratios required by the consent order.

We have agreed with and submitted to the FDIC, the KDFI and the Federal Reserve Bank of St. Louis a plan to restore our capital ratios to levels that comply with our regulatory agreements. We are evaluating various specific initiatives to increase our regulatory capital and reduce our total assets. Strategic alternatives include divesting of branch offices, selling loans and raising capital by selling stock.

Our ability to raise additional capital will depend on, among other things, conditions in the capital markets at that time, which are outside of our control, and our financial performance, including the management of our revenue, expenses, levels of average assets, credit quality, and levels of other real estate owned. We may not have access to capital on acceptable terms or at all. Our inability to raise additional capital on acceptable terms when needed could have a material adverse effect on our businesses, financial condition and results of operations. In addition, if we are unable to comply with our regulatory capital requirements, it could result in more stringent enforcement actions by the bank regulatory agencies, which could damage our reputation and have a material adverse effect on our business.

**Our ability to pay cash dividends on our common and preferred stock and pay interest on the junior subordinated debentures that relate to our trust preferred securities is currently restricted. Our inability to resume paying dividends and distributions on these securities may adversely affect our common shareholders.**

We historically paid quarterly cash dividends on our common stock until we suspended dividend payments in October 2011. Effective with the fourth quarter of 2011, we began deferring cash dividends on the Series A Preferred Stock held by the U.S. Treasury and interest payments on the junior subordinated notes relating to our trust preferred securities. Deferring interest payments on the junior subordinated notes resulted in a deferral of distributions on our trust preferred securities. We will be prohibited from paying cash dividends on our common stock until such time as we have paid all deferred dividends on our Series A Preferred Stock and all deferred distributions on our trust preferred securities.

If we defer interest payments on our trust preferred securities for 20 consecutive quarters, we must pay all deferred interest and resume quarterly interest payments or we will be in default. If we miss six quarterly dividend payments on the Series A preferred stock, whether or not consecutive, the U.S. Treasury will have the right to appoint two directors to our board of directors until all accrued but unpaid dividends have been paid. Dividends on the Series A preferred stock and deferred distributions on our trust preferred securities are cumulative and therefore unpaid dividends and distributions will accrue and compound on each subsequent payment date. If we become subject to any liquidation, dissolution or winding up of affairs, holders of the trust preferred securities and then holders of the preferred stock will be entitled to receive the liquidation amounts to which they are entitled including the amount of any accrued and unpaid distributions and dividends, before any distribution to the holders of common stock.

**Our business has been and may continue to be adversely affected by current conditions in the financial markets and by economic conditions generally.**

Although the economic slowdown that the United States has experienced since 2008 has begun to reverse and the markets have generally improved, businesses across a wide range of industries continue to face serious difficulties due to the lack of consumer spending and the lack of liquidity in the global credit markets. Ongoing weakness in business and economic conditions generally or specifically in our markets has had, and could continue to have one or more of the following adverse effects on our business:



- A decrease in the demand for loans and other products and services offered by us;
- A decrease in the value of collateral securing our loans;
- An impairment of certain intangible assets, such as core deposit intangibles; and
- An increase in the number of customers who become delinquent, file for protection under bankruptcy laws or default on their loans.

The general business environment has had an adverse effect on our business during the past four years. Although the general business environment has shown some improvement, there can be no assurance that such improvement can be sustained. In addition, the improvement of certain economic indicators, such as real estate asset values and rents and unemployment, may vary between geographic markets and may continue to lag behind improvement in the overall economy. These economic indicators typically affect the real estate and financial services industries, in which we have a significant number of customers, more significantly than other economic sectors. Furthermore, we have a substantial lending business that depends upon the ability of borrowers to make debt service payments on loans. Should unemployment or real estate asset values fail to recover for an extended period of time, or if economic conditions worsen or remain volatile, our business, financial condition or results of operations could be adversely affected.

**A large percentage of our loans are collateralized by real estate, and prolonged weakness in the real estate market may result in losses and adversely affect our profitability.**

Approximately 89.3% of our loan portfolio as of December 31, 2012, was comprised of commercial and residential loans collateralized by real estate. Adverse economic conditions since 2008 have decreased demand for real estate which has depressed real estate values in our markets. Persistent weakness in the real estate market could continue to significantly impair the value of our collateral and our ability to sell the collateral upon foreclosure. The real estate collateral in each case provides an alternate source of repayment in the event of default by the borrower and may deteriorate in value during the time the credit is extended. If real estate values decline further, it will become more likely that we would be required to increase our allowance for loan losses. If during a period of reduced real estate values, we are required to liquidate the collateral securing a loan to satisfy the debt or to increase our allowance for loan losses, it could materially reduce our profitability and adversely affect our financial condition.

**We have a significant percentage of real estate construction and development loans, which carry a higher degree of risk. Persistent weakness in the residential construction and commercial development real estate markets has increased the non-performing assets in our loan portfolio and our provision expense for losses on loans. These impacts have had, and could continue to have a material adverse effect on our capital, financial condition and results of operations.**

Approximately 7.8% of our loan portfolio as of December 31, 2012, consisted of real estate construction and development loans. These loans generally carry a higher degree of risk than long-term financing of existing properties because repayment depends on the ultimate completion of the project and usually on the sale of the property. If we are forced to foreclose on a project prior to its completion, we may not be able to recover the entire unpaid portion of the loan or we may be required to fund additional money to complete the project or hold the property for an indeterminate period of time. Any of these outcomes may result in losses and adversely affect our profitability.

Residential construction and commercial development real estate activity in our markets continues to be affected by challenging economic conditions. Prolonged weakness in these sectors may lead to additional valuation adjustments on our loan portfolios and real estate owned as we continue to reassess the fair value of our non-performing assets, the loss severity of loans in default and the fair value of real estate owned. We also may realize additional losses in connection with our disposition of non-performing assets. A weak real estate market could further reduce demand for residential housing, which, in turn, could adversely affect real estate development and construction activities. Consequently, the longer the current economic conditions persist, the more likely they are to adversely affect the ability of residential real estate developer borrowers to repay these loans and the value of property used as collateral for such loans. These economic conditions and market factors have negatively affected some of our larger loans, causing our total net-charge offs to increase and requiring us to significantly increase our allowance for loan losses. If adverse economic conditions persist, these trends could continue to worsen. Any further increase in our non-performing assets and related increases in our provision expense for losses on loans could negatively affect our business and could have a material adverse effect on our capital, financial condition and results of operations.

**Our decisions regarding credit risk may not be accurate, and our allowance for loan losses may not be sufficient to cover actual losses, which could adversely affect our business, financial condition and results of operations.**

We maintain an allowance for loan losses at a level we believe is adequate to absorb probable incurred losses in our loan portfolio based on historical loan loss experience, specific problem loans, value of underlying collateral and other relevant factors. If our assessment of these factors is ultimately inaccurate, the allowance may not be sufficient to cover actual future loan losses, which would adversely affect our operating results. Our estimates are subjective, and their accuracy depends on the outcome of future events. Changes in economic, operating and other conditions that are generally beyond our control could cause actual loan losses to increase significantly. In addition, bank regulatory agencies, as an integral part of their supervisory functions, periodically review the adequacy of our allowance for loan losses. Regulatory agencies have from time to time required us to increase our provision for loan losses or to recognize additional loan charge-offs when their judgment has differed from ours. Any of these events could have a material negative impact on our operating results.

Our levels of additional classified loans and non-performing assets may increase in the foreseeable future if economic conditions remain weak and cause more borrowers to default. Further, the value of the collateral underlying a given loan, and the realizable value of such collateral in a foreclosure sale, are likely to decline if the real estate markets remain weak, making us less likely to realize a full recovery if a borrower defaults on a loan. Any additional increases in the level of our non-performing assets, loan charge-offs or provision for loan losses, or our inability to realize the full value of underlying collateral in the event of a loan default, could negatively affect our business, financial condition, and results of operations and the trading price of our securities.

**We have had difficulty maintaining effective internal controls over loan grading.**

As of December 31, 2011, management determined that our controls regarding the determination of loan grades were not operating effectively. Specifically, our internal control process surrounding loan grades, which consists of a combination of internal and external loan review activities, identified and corrected the grades for the majority of loans that were not initially graded correctly. However, we determined that such loan review did not sufficiently cover all loans subject to potential grading error during 2011. We expanded the scope of our controls to cover the remainder of the portfolio and adjusted our allowance for loan losses as of December 31, 2011 to take the additional findings into consideration. Although the Company has determined as of December 31, 2012 that this weakness has been remediated, it is possible that we could have additional internal control weakness in this area in future periods.

**If we experience greater credit losses than anticipated, our operating results may be adversely affected.**

As a lender, we are exposed to the risk that our customers will be unable to repay their loans according to their terms and that any collateral securing the payment of their loans may not be sufficient to assure repayment. Credit losses are inherent in the business of making loans and could have a material adverse effect on our operating results. Our credit risk with respect to our real estate and construction loan portfolio will relate principally to the creditworthiness of borrowers and the value of the real estate serving as security for the repayment of loans. Our credit risk with respect to our commercial and consumer loan portfolio will relate principally to the general creditworthiness of businesses and individuals within our local markets.

We make various assumptions and judgments about the collectability of our loan portfolio and provide an allowance for estimated credit losses based on a number of factors. We believe that our allowance for credit losses is adequate. However, if our assumptions or judgments are wrong, our allowance for credit losses may not be sufficient to cover our actual credit losses. We may have to increase our allowance in the future in response to the request of one of our primary banking regulators, to adjust for changing conditions and assumptions, or as a result of any deterioration in the quality of our loan portfolio. The actual amount of future provisions for credit losses cannot be determined at this time and may vary from the amounts of past provisions.

**We continue to hold and acquire a significant amount of OREO properties, which could increase operating expenses and result in future losses to the Company.**

During recent years, we have acquired a significant amount of real estate as a result of foreclosure or by deed in lieu of foreclosure that is listed on our balance sheet as other real estate owned (OREO). This increase in our OREO portfolio has increased the expenses we have incurred to manage and dispose of these properties, which sometimes includes funding construction required to facilitate sale. We expect that our operating results in 2013 will continue to be adversely affected by expenses associated with OREO, including insurance and taxes, completion and repair costs, as well as by the funding costs associated with assets that are tied up in OREO.

Properties in our OREO portfolio are recorded at the lower of the recorded investment in the loans for which the properties previously served as collateral or "fair value," which represents the estimated sales price of the properties on the date acquired less estimated selling costs. Generally, in determining "fair value" an orderly disposition of the property is assumed, except where a different disposition strategy is expected. Significant judgment is required in estimating the fair value of OREO, and the period of time within which such estimates can be considered current may change during periods of market volatility, such as we have experienced since 2008.

Any further decreases in market prices of real estate in our market areas may lead to additional OREO write downs, with a corresponding expense in our income statement. We evaluate OREO property values periodically and write down the carrying value of the properties if and when the results of our evaluations require it.

In response to market conditions and other economic factors, we may utilize alternative sale strategies other than orderly disposition as part of our OREO disposition strategy, such as bulk sales. In this event, as a result of the significant judgments required in estimating fair value and the variables involved in different methods of disposition, the net proceeds realized from such sales transactions could differ significantly from appraisals, comparable sales, and other estimates used to determine the fair value of our OREO properties. In addition, our disposition of OREO through alternative sales strategies could impact the fair value of comparable OREO properties remaining in our portfolio.

**Our profitability depends significantly on local economic conditions.**

Because most of our business activities are conducted in central Kentucky and most of our credit exposure is in that region, we are at risk from adverse economic or business developments affecting this area, including declining regional and local business and employment activity, a downturn in real estate values and agricultural activities and natural disasters. To the extent the central Kentucky economy remains weak, the rates of delinquencies, foreclosures, bankruptcies and losses in our loan portfolio will likely increase. Moreover, the value of real estate or other collateral that secures our loans could be adversely affected by the economic downturn or a localized natural disaster. The economic downturn has had a negative impact on our financial results and may continue to have a negative impact on our business, financial condition, results of operations and future prospects.

**Our small to medium-sized business portfolio may have fewer resources to weather the downturn in the economy.**

Our portfolio includes loans to small and medium-sized businesses and other commercial enterprises. Small and medium-sized businesses frequently have smaller market shares than their competitors, may be more vulnerable to economic downturns, often need substantial additional capital to expand or compete and may experience substantial variations in operating results, any of which may impair a borrower's ability to repay a loan. In addition, the success of a small or medium-sized business often depends on the management talents and efforts of one or two persons or a small group of persons, and the death, disability or resignation of one or more of these persons could have a material adverse impact on the business and its ability to repay our loan. A continued economic downturn could have a more pronounced negative impact on our target market, which could cause us to incur substantial credit losses that could materially harm our operating results.

**Our profitability is vulnerable to fluctuations in interest rates.**

Changes in interest rates could harm our financial condition or results of operations. Our results of operations depend substantially on net interest income, the difference between interest earned on interest-earning assets (such as investments and loans) and interest paid on interest-bearing liabilities (such as deposits and borrowings). Interest rates are highly sensitive to many factors, including governmental monetary policies and domestic and international economic and political conditions. Factors beyond our control, such as inflation, recession, unemployment and money supply may also affect interest rates. If our interest-earning assets mature or reprice more quickly than our interest-bearing liabilities in a given period as a result of decreasing interest rates, our net interest income may decrease. Likewise, our net interest income may decrease if interest-bearing liabilities mature or reprice more quickly than interest-earning assets in a given period as a result of increasing interest rates.

Fixed-rate loans increase our exposure to interest rate risk in a rising rate environment because interest-bearing liabilities would be subject to repricing before assets become subject to repricing. Adjustable-rate loans decrease the risk associated with changes in interest rates but involve other risks, such as the inability of borrowers to make higher payments in an increasing interest rate environment. At the same time, for secured loans, the marketability of the underlying collateral may be adversely affected by higher interest rates. In a declining interest rate environment, there may be an increase in prepayments on loans as the borrowers refinance their loans at lower interest rates, which could reduce net interest income and harm our results of operations.

**If we cannot obtain adequate funding, we may not be able to meet the cash flow requirements of our depositors and borrowers, or meet the operating cash needs of the Company to fund corporate expansion or other activities.**

Our liquidity policies and limits are established by the Board of Directors of PBI Bank, with operating limits set by the Asset Liability Committee ("ALCO"), based upon analyses of the ratio of loans to deposits and the percentage of assets funded with non-core or wholesale funding. The ALCO regularly monitors the overall liquidity position of PBI Bank and the Company to ensure that various alternative strategies exist to cover unanticipated events that could affect liquidity. Liquidity is the ability to meet cash flow needs on a timely basis at a reasonable cost. If our liquidity policies and strategies don't work as well as intended, then we may be unable to make loans and to repay deposit liabilities as they become due or are demanded by customers. The ALCO follows established board approved policies and monitors guidelines to diversify our wholesale funding sources to avoid concentrations in any one-market source. Wholesale funding sources include Federal funds purchased, securities sold under repurchase agreements, non-core brokered deposits, and Federal Home Loan Bank ("FHLB") advances that are collateralized with mortgage-related assets.

We maintain a portfolio of securities that can be used as a secondary source of liquidity. There are other available sources of liquidity, including additional collateralized borrowings such as FHLB advances, the issuance of debt securities, and the issuance of preferred or common securities in public or private transactions. If we were unable to access any of these funding sources when needed, we might not be able to meet the needs of our customers, which could adversely impact our financial condition, our results of operations, cash flows and our level of regulatory-qualifying capital.

**We may need to raise additional capital in the future by selling capital stock. Future sales or other dilution of our equity may adversely affect the market price of our common stock.**

We are not restricted from issuing additional common stock, including securities that are convertible into or exchangeable for, or that represent the right to receive, common stock. The issuance of additional shares of common stock or the issuance of convertible securities would dilute the ownership interest of our existing common shareholders. The market price of our common stock could decline as a result of such an offering as well as other sales of a large block of shares of our common stock or similar securities in the market after such an offering, or the perception that such sales could occur.

Our stock has traded from time-to-time at a price below our book value per share. Accordingly, a sale of common shares at or below our stock price would be dilutive to current shareholders.

**As a bank holding company, we depend on dividends and distributions paid by our banking subsidiary.**

Porter Bancorp is a legal entity separate and distinct from PBI Banks and our other subsidiaries. Our principal source of cash flow, from which we would fund any dividends paid to our shareholders, has historically been dividends Porter Bancorp receives from PBI Bank. Regulations of the FDIC and the KDFI govern the ability of PBI Bank to pay dividends and other distributions to us, and regulations of the Federal Reserve govern our ability to pay dividends or make other distributions to our shareholders. In its consent order with the FDIC and the KDFI, PBI Bank agreed not to pay dividends to us without the prior consent of those regulators. During 2011, Porter Bancorp contributed \$13.1 million to PBI Bank. The contribution, which was made to strengthen PBI Bank's capital in an effort to help it comply with its capital ratio requirements under the consent order, also substantially decreased the liquid assets of Porter Bancorp. Liquid assets decreased from \$20.3 million at December 31, 2010, to \$4.9 million at December 31, 2011, and to \$3.5 million at December 31, 2012. Since PBI Bank is unlikely to be in a position to pay dividends to Porter Bancorp for the foreseeable future, cash inflows for Porter Bancorp are limited to earnings on investment securities, sales of investment securities, and interest on its deposits held at PBI Bank. These cash inflows, along with the liquid assets held at December 31, 2012, are needed to cover ongoing operating expenses of Porter Bancorp, which have been reduced and are budgeted at \$1.1 million for 2013. Parent company liquidity could be improved by raising capital. See the "Supervision-Porter Bancorp-Dividends" section of Item 1. "Business" and the "Dividends" section of Item 5. "Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities" of this Annual Report on Form 10-K.

**We may not pay dividends on your common stock and we have agreed with the Federal Reserve to obtain its written consent before declaring or paying any future dividends.**

Holders of shares of our common stock are only entitled to receive such dividends as our board of directors may declare from funds legally available for such payments. Although we have historically declared cash dividends on our common stock, we currently do not pay a cash dividend and we are not required to do so. Also, because we have issued preferred stock to the U.S. Treasury under its Capital Purchase Program ("CPP"), our ability to increase our dividend or to repurchase our common stock is limited for so long as any securities issued under such program remain outstanding, as discussed in greater detail in the "Dividends" section of Item 5. "Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities" of this Annual Report on Form 10-K. There can be no assurance that we will pay dividends to our shareholders in the future, or if dividends are paid, that we will increase our dividend to historical levels or otherwise. Our ability to pay dividends to our shareholders is not only subject to limitations imposed by the terms of the CPP, but also by limitations and guidance issued by the Federal Reserve. For example, under Federal Reserve guidance, bank holding companies generally are advised to consult in advance with the Federal Reserve before declaring dividends, and to strongly consider reducing, deferring or eliminating dividends, in certain situations, such as when declaring or paying a dividend that would exceed earnings for the fiscal quarter for which the dividend is being paid, or when declaring or paying a dividend that could result in a material adverse change to the organization's capital structure. In addition, Porter Bancorp has agreed with the Federal Reserve to obtain its written consent prior to declaring or paying any future dividends. As a practical matter, Porter Bancorp cannot pay dividends for the foreseeable future.

**We may not be able to realize the value of our tax losses and deductions.**

Due to our losses, we have a net operating loss carry-forward of \$15.0 million, credit loss carry-forwards of \$692,000, and other net deferred tax assets of \$28.2 million. In order to realize the benefit of these tax losses, credits and deductions, we will need to generate substantial taxable income in future periods. We established a 100% valuation allowance for all deferred tax assets in 2011. Should the Company issue new shares to raise additional capital, a change in control could be triggered, as defined by Section 382 of the Internal Revenue Code, which could negatively impact or limit the ability to utilize our net operating loss carry-forwards, credit loss carry-forwards, and other net deferred tax assets.

**Our issuance of securities to the U.S. Department of the Treasury may limit our ability to return capital to our shareholders and is dilutive to our common shares. In addition, the dividend rate increases substantially after five years if we do not redeem the shares by that time.**

On November 21, 2008, we sold \$35 million of senior preferred stock to the U.S. Treasury as part of the Capital Purchase Program established under the Emergency Economic Stabilization Act of 2008. Unless we are able to redeem the preferred stock by November 21, 2013, the dividends on this capital will increase substantially at that point, from 5% (approximately \$1.75 million annually) to 9% (approximately \$3.15 million annually). Depending on market conditions and our financial performance at the time, this increase in dividends could significantly impact our capital, liquidity and earnings available to common shareholders.

The terms of the transaction with the U.S. Treasury limit our ability to pay dividends and repurchase our shares. We will not be able to pay any dividends on our common stock unless and until we are current on our dividend payments on the preferred shares. Effective with the fourth quarter of 2011, we began deferring the payment of regular quarterly cash dividends on this preferred stock. These restrictions may have an adverse effect on the market price of our common stock.

**The U.S. Treasury has the unilateral ability to change some of the restrictions imposed on us by virtue of our sale of securities to it.**

In addition to the restrictions our ability to pay dividends or repurchase our stock, our preferred stock purchase agreement with the U.S. Treasury authorizes the U.S. Treasury to unilaterally amend the agreement to the extent required to comply with any future changes in federal statutes. Following our November 21, 2008 issuance of senior preferred stock to the U.S. Treasury, the agreement was amended to impose restrictions on the conduct of our business, including restrictions on the compensation we can pay to executive officers and corporate governance requirements. These restrictions could have an adverse impact on the conduct of our business, as could any additional amendments in the future that impose further requirements or amend existing requirements.

**Our chairman and chairman emeritus together have sufficient voting power to elect or remove our directors, to determine the vote on any matter that requires shareholder approval, and otherwise control our company. In exercising their voting power, they may act according to their own interests, which may be adverse to your interests.**

As of December 31, 2012, J. Chester Porter and Maria L. Bouvette together beneficially owned approximately 6,072,216 shares, or 50.6% of our outstanding common stock. Mr. Porter has made arrangements that provide for Ms. Bouvette to retain voting control of his common stock in the event of death or incapacity. Ms. Bouvette has made similar arrangements that provide for a committee including Mr. Porter and two of her siblings to retain voting control of her common stock in the event of death or incapacity. Accordingly, Mr. Porter and Ms. Bouvette currently have the power to exercise control over our business and affairs and to determine the outcome of any matter submitted to a vote of our shareholders, including the election and removal of a majority of our board of directors, any amendment of our articles of incorporation (including any amendment that changes the rights of our common stock) and any merger, consolidation or sale of all or substantially all of our assets. Mr. Porter and Ms. Bouvette could take actions or make decisions in their self-interest that are opposed to your best interests. They could remove directors who take actions or make decisions they oppose but are favored by our other shareholders. They may be less receptive to the desires communicated by shareholders. Neither our articles of incorporation, our bylaws, nor Kentucky law requires the vote of more than a simple majority of our outstanding shares of common stock to approve a matter submitted for shareholder approval, subject to the general statutory requirement that any transaction in which one or more directors have a direct or indirect interest (other than as a shareholder) must be "fair" to the corporation. Mr. Porter and Ms. Bouvette have a level of concentrated control that could discourage others from initiating any potential merger, takeover or other change of control transaction that may otherwise give you the opportunity to realize a premium over the then-prevailing market price of our common stock. As a result, the market price of our common stock could be adversely affected.

**We are a “controlled company” within the meaning of the NASDAQ corporate governance rules because J. Chester Porter and Maria L. Bouvette together own more than 50% of our sole class of voting stock. As a controlled company, our controlling shareholders have greater power to make decisions in their own self-interest and against the interests of other shareholders, and investors and other shareholders will have fewer procedural and substantive protections against the exercise of this power.**

A “controlled company” may elect not to comply with the following NASDAQ corporate governance rules, which require that:

- a majority of its board of directors consists of “independent directors,” which the NASDAQ rules define as persons who are not either officers or employees of the company and have no relationships that, in the opinion of the board of directors, would interfere with the exercise of independent judgment in carrying out their responsibilities as directors;
- decisions regarding the compensation paid to executive officers are made either by a compensation committee composed entirely of independent directors or by a majority of the independent directors; and
- nominations for election to the board of directors are made either by a nominating committee composed entirely of independent directors with a written charter addressing the committee’s purpose and responsibilities or by a majority of the independent directors.

Although a majority of our directors are independent directors, Mr. Porter and Ms. Bouvette, together have the voting power to remove directors who oppose actions or decisions they favor. Mr. Porter and Ms. Bouvette also have the power to elect a majority of directors who are not independent directors. Our board may elect to dispense with the nominating and governance committee at any time without shareholder consent. Accordingly, our shareholders have fewer procedural and substantive protections than shareholders of companies subject to all of the NASDAQ corporate governance requirements.

**Higher FDIC deposit insurance premiums and assessments could significantly increase our non-interest expense.**

Our deposits are insured by the FDIC up to legal limits and, accordingly, we are subject to FDIC deposit insurance assessments. High levels of bank failures over the past three years and increases in the statutory deposit insurance limits have increased resolution costs to the FDIC and put pressure on the DIF. In order to maintain a strong funding position and restore the reserve ratios of the DIF, the FDIC increased assessment rates on insured institutions, charged a special assessment to all insured institutions as of June 30, 2009 and required banks to prepay three years’ worth of premiums on December 30, 2009. If there are additional financial institution failures, we may be required to pay even higher FDIC premiums than the recently increased levels, or the FDIC may charge additional special assessments. Further, the FDIC recently increased the DIF’s target reserve ratio to 2.0 percent of insured deposits following the Dodd-Frank Act’s elimination of the 1.5 percent cap on the DIF’s reserve ratio. Additional increases in our assessment rate may be required in the future to achieve this targeted reserve ratio. These recent increases in deposit assessments and any future increases, required prepayments or special assessments of FDIC insurance premiums may adversely affect our business, financial condition or results of operations.

Additionally, pursuant to the Dodd-Frank Act, the FDIC amended its regulations regarding assessment for federal deposit insurance to base such assessments on the average total consolidated assets of the insured institution during the assessment period, less the average tangible equity of the institution during the assessment period. Prior to this change, we were assessed only on deposit balances. The FDIC adopted a rule implementing this change, as well as adopting a revised risk-based assessment calculation in February 2011. The FDIC has also proposed a rule tying assessment rates of FDIC-insured institutions to the institution’s employee compensation programs. The exact nature and cumulative effect of these recent changes are not yet known, but they are expected to increase the amount of premiums we must pay for FDIC insurance. Any such increase may adversely affect our business, financial condition or results of operations.

**We face strong competition from other financial institutions and financial service companies, which could adversely affect our results of operations and financial condition.**

We compete with other financial institutions in attracting deposits and making loans. Our competition in attracting deposits comes principally from other commercial banks, credit unions, savings and loan associations, securities brokerage firms, insurance companies, money market funds and other mutual funds. Our competition in making loans comes principally from other commercial banks, credit unions, savings and loan associations, mortgage banking firms and consumer finance companies. In addition, competition for business in the Louisville metropolitan area has grown in recent years as changes in banking law have allowed several banks to enter the market by establishing new branches. Likewise, competition is increasing in the other growing markets we have targeted, which may adversely affect our ability to execute our plans for expansion. Moreover, our advantage from having operated a nationally recognized online banking division since 1999 may diminish, as nearly all of our competitors now offer online banking and may become more successful in attracting online business over time as they become more experienced.

Competition in the banking industry may also limit our ability to attract and retain banking clients. We maintain smaller staffs of associates and have fewer financial and other resources than larger institutions with which we compete. Financial institutions that have far greater resources and greater efficiencies than we do may have several marketplace advantages resulting from their ability to:

- offer higher interest rates on deposits and lower interest rates on loans than we can;
- offer a broader range of services than we do;
- maintain more branch locations than we do; and
- mount extensive promotional and advertising campaigns.

In addition, banks and other financial institutions with larger capitalization and other financial intermediaries may not be subject to the same regulatory restrictions as we are and may have larger lending limits than we do. Some of our current commercial banking clients may seek alternative banking sources as they develop needs for credit facilities larger than we can accommodate. If we are unable to attract and retain customers, we may not be able to maintain growth and our results of operations and financial condition may otherwise be negatively impacted.

**We depend on our senior management team, and the unexpected loss of one or more of our senior executives could impair our relationship with customers and adversely affect our business and financial results.**

Our future success significantly depends on the continued services and performance of our key management personnel. Our future performance will depend on our ability to motivate and retain these and other key officers. The Dodd-Frank Act, legislation governing participants in the U.S. Treasury's CPP program and the policies of bank regulatory agencies have placed restrictions on our executive compensation practices. Such restrictions and standards may further impact our company's ability to compete for talent with other businesses and financial institutions that are not subject to the same limitations as we are. The loss of the services of members of our senior management or other key officers or our inability to attract additional qualified personnel as needed could materially harm our business.

**Our reported financial results depend on management's selection of accounting methods and certain assumptions and estimates.**

Our accounting policies and assumptions are fundamental to our reported financial condition and results of operations. Our management must exercise judgment in selecting and applying many of these accounting policies and methods so they comply with generally accepted accounting principles and reflect management's judgment of the most appropriate manner to report our financial condition and results. In some cases, management must select the accounting policy or method to apply from two or more alternatives, any of which may be reasonable under the circumstances, yet may result in our reporting materially different results than would have been reported under a different alternative.

Certain accounting policies are critical to presenting our reported financial condition and results. They require management to make difficult, subjective or complex judgments about matters that are uncertain. Materially different amounts could be reported under different conditions or using different assumptions or estimates. These critical accounting policies include the allowance for credit losses, intangible assets, and income taxes. Because of the uncertainty of estimates involved in these matters, we may be required to do one or more of the following: significantly increase the allowance for credit losses and/or sustain credit losses that are significantly higher than the reserve provided; recognize significant impairment on our other intangible assets or significantly increase our accrued income taxes.

**While management continually monitors and improves our system of internal controls, data processing systems, and corporate wide processes and procedures, we may suffer losses from operational risk in the future.**

Management maintains internal operational controls, and we have invested in technology to help us process large volumes of transactions. However, we may not be able to continue processing at the same or higher levels of transactions. If our systems of internal controls should fail to work as expected, if our systems were to be used in an unauthorized manner, or if employees were to subvert the system of internal controls, significant losses could occur.

We process large volumes of transactions on a daily basis and are exposed to numerous types of operational risk, which could cause us to incur substantial losses. Operational risk resulting from inadequate or failed internal processes, people, and systems includes the risk of fraud by employees or persons outside of our company, the execution of unauthorized transactions by employees, errors relating to transaction processing and systems, and breaches of the internal control system and compliance requirements. This risk of loss also includes potential legal actions that could arise as a result of the operational deficiency or as a result of noncompliance with applicable regulatory standards.

We establish and maintain systems of internal operational controls that provide management with timely and accurate information about our level of operational risk. While not foolproof, these systems have been designed to manage operational risk at appropriate, cost effective levels. We have also established procedures that are designed to ensure that policies relating to conduct, ethics and business practices are followed. Nevertheless, we experience loss from operational risk from time to time, including the effects of operational errors, and these losses may be substantial.

**Our information systems may experience an interruption or security breach.**

Failure in or breach of our operational or security systems or infrastructure, or those of our third party vendors and other service providers, including as a result of cyber attacks, could disrupt our businesses, result in the disclosure or misuse of confidential or proprietary information, damage our reputation, increase our costs and cause losses. As a large financial institution, we depend on our ability to process, record and monitor a large number of customer transactions on a continuous basis. As customer, public and regulatory expectations regarding operational and information security have increased, our operational systems and infrastructure must continue to be safeguarded and monitored for potential failures, disruptions and breakdowns. Our business, financial, accounting, data processing systems or other operating systems and facilities may stop operating properly or become disabled or damaged as a result of a number of factors including events that are wholly or partially beyond our control. For example, there could be sudden increases in customer transaction volume; electrical or telecommunications outages; natural disasters such as earthquakes, tornadoes, and hurricanes; disease pandemics; events arising from local or larger scale political or social matters, including terrorist acts; and, as described below, cyber attacks. Although we have business continuity plans and other safeguards in place, our business operations may be adversely affected by significant and widespread disruption to our physical infrastructure or operating systems that support our businesses and customers.

Information security risks for financial institutions have generally increased in recent years in part because of the proliferation of new technologies, the use of the Internet and telecommunications technologies to conduct financial transactions, and the increased sophistication and activities of organized crime, hackers, terrorists, activists, and other external parties. As noted above, our operations rely on the secure processing, transmission and storage of confidential information in our computer systems and networks. In addition, to access our products and services, our customers may use personal smartphones, tablet PC's, and other mobile devices that are beyond our control systems. Although we believe we have robust information security procedures and controls, our technologies, systems, networks, and our customers' devices may become the target of cyber attacks or information security breaches that could result in the unauthorized release, gathering, monitoring, misuse, loss or destruction of our customers' confidential, proprietary and other information or that of our customers, or otherwise disrupt the business operations of ourselves, our customers or other third parties.

Third parties with which we do business or that facilitate our business activities, could also be sources of operational and information security risk to us, including from breakdowns or failures of their own systems or capacity constraints. Although to date we have not experienced any material losses relating to cyber attacks or other information security breaches, there can be no assurance that we will not suffer such losses in the future. Our risk and exposure to these matters remains heightened because of, among other things, the evolving nature of these threats and the prevalence of Internet and mobile banking. As cyber threats continue to evolve, we may be required to expend significant additional resources to continue to modify or enhance our protective measures or to investigate and remediate any information security vulnerabilities. Disruptions or failures in the physical infrastructure or operating systems that support our businesses and customers, or cyber attacks or security breaches of the networks, systems or devices that our customers use to access our products and services could result in customer attrition, regulatory fines, penalties or intervention, reputational damage, reimbursement or other compensation costs, and/or additional compliance costs, any of which could materially adversely affect our business, results of operations or financial condition.

**We operate in a highly regulated environment and, as a result, are subject to extensive regulation and supervision that could adversely affect our financial performance and our ability to implement our growth and operating strategies.**

We are subject to examination, supervision and comprehensive regulation by federal and state regulatory agencies, which is described under "Item 1 – Business—Supervision and Regulation." Regulatory oversight of banks is primarily intended to protect depositors, the federal deposit insurance funds, and the banking system as a whole, not our shareholders. Compliance with these regulations is costly and may make it more difficult to operate profitably.



Federal and state banking laws and regulations govern numerous matters including the payment of dividends, the acquisition of other banks and the establishment of new banking offices. We must also meet specific regulatory capital requirements. Our failure to comply with these laws, regulations and policies or to maintain our capital requirements could affect our ability to pay dividends on common stock, our ability to grow through the development of new offices and our ability to make acquisitions. These limitations may prevent us from successfully implementing our growth and operating strategies.

In addition, the laws and regulations applicable to banks could change at any time, which could significantly impact our business and profitability. For example, new legislation or regulation could limit the manner in which we may conduct our business, including our ability to attract deposits and make loans. Events that may not have a direct impact on us, such as the bankruptcy or insolvency of a prominent U.S. corporation, can cause legislators and banking regulators and other agencies such as the Financial Accounting Standards Board, the SEC, the Public Company Accounting Oversight Board and various taxing authorities to respond by adopting and or proposing substantive revisions to laws, regulations, rules, standards, policies and interpretations. The nature, extent, and timing of the adoption of significant new laws and regulations, or changes in or repeal of existing laws and regulations may have a material impact on our business and results of operations. Changes in regulation may cause us to devote substantial additional financial resources and management time to compliance, which may negatively affect our operating results.

**Changes in banking laws could have a material adverse effect on us.**

We are subject to changes in federal and state laws as well as changes in banking and credit regulations, and governmental economic and monetary policies. We cannot predict whether any of these changes may adversely and materially affect us. The current regulatory environment for financial institutions entails significant potential increases in compliance requirements and associated costs. Federal and state banking regulators also possess broad powers to take supervisory actions as they deem appropriate. These supervisory actions may result in higher capital requirements, higher insurance premiums and limitations on our activities that could have a material adverse effect on our business and profitability.

**Recent legislation regarding the financial services industry may have a significant adverse effect on our operations.**

The Dodd-Frank Act was signed into law on July 21, 2010. The Dodd-Frank Act will implement significant changes to the U.S. financial system, including among others:

- new requirements on banking, derivative and investment activities, including the repeal of the prohibition on the payment of interest on business demand accounts, and debit card interchange fee requirements;
- the creation of a new Consumer Financial Protection Bureau (“CFPB”) with supervisory authority, including the power to conduct examinations and take enforcement actions with respect to financial institutions with assets of \$10 billion or more and implement regulations that will affect all financial institutions;
- provisions affecting corporate governance and executive compensation of all companies subject to the reporting requirements of the Securities and Exchange Act of 1934, as amended; and
- a provision that would require bank regulators to set minimum capital levels for bank holding companies that are as strong as those required for their insured depository subsidiaries, subject to a grandfather clause for holding companies with less than \$15 billion in assets as of December 31, 2009.

Many provisions in the Dodd-Frank Act remain subject to regulatory rule-making and implementation, the effects of which are not yet known. As a result, it is difficult to gauge the ultimate impact of certain provisions of the Dodd-Frank Act because the implementation of many concepts is left to regulatory agencies. For example, the CFPB is given the power to adopt new regulations to protect consumers and is given control over existing consumer protection regulations adopted by federal banking regulators. The CFPB has begun the rule-making process but it is not known at this time when any rules will be finalized and implemented.

The provisions of the Dodd-Frank Act and any rules adopted to implement those provisions as well as any additional legislative or regulatory changes may impact the profitability of our business activities and costs of operations, require that we change certain of our business practices, materially affect our business model or affect retention of key personnel, require us to raise additional regulatory capital, including additional Tier 1 capital, and could expose us to additional costs (including increased compliance costs). These and other changes may also require us to invest significant management attention and resources to make any necessary changes and may adversely affect our ability to conduct our business as previously conducted or our results of operations or financial condition.

**Item 1B. Unresolved Staff Comments**

Not applicable.

**Item 2. Properties**

PBI Bank has 18 full-service banking offices. The following table shows the location, square footage and ownership of each property. We believe that each of these locations is adequately insured. Data processing and support operations are located in the Main office in Louisville and the Glasgow office building on Columbia Avenue. Trust services and operations are located in the Campbell Lane office in Bowling Green.

<b>Markets</b>	<b>Square Footage</b>	<b>Owned/Leased</b>
<b>Louisville/Jefferson, Bullitt and Henry Counties</b>		
Main Office: 2500 Eastpoint Parkway, Louisville	30,000	Owned
Eminence Office: 645 Elm Street, Eminence	1,500	Owned
Hillview Office: 11998 Preston Highway, Hillview	3,500	Owned
Pleasureville Office: 5440 Castle Highway, Pleasureville	10,000	Owned
Shepherdsville Office: 340 South Buckman Street, Shepherdsville	10,000	Owned
Conestoga Office: 155 Conestoga Parkway, Shepherdsville	3,900	Owned
<b>Lexington/Fayette County</b>		
Lexington Office: 2424 Harrodsburg Road, Suite 100, Lexington	8,500	Leased
<b>South Central Kentucky</b>		
Brownsville Office: 113 East Main, Brownsville	8,500	Owned
Greensburg Office: 202-04 North Main Street, Greensburg	11,000	Owned
Horse Cave Office: 210 East Main Street, Horse Cave	5,000	Owned
Morgantown Office: 112 West Logan Street, Morgantown	7,500	Owned
Munfordville Office: 949 South Dixie Highway, Munfordville	9,000	Owned
Northside Office: 1300 North Main Street, Beaver Dam	3,200	Owned
Wal-Mart Office: 1701 North Main Street, Beaver Dam	500	Leased
<b>Owensboro/Daviess County</b>		
Owensboro Office: 1819 Frederica Street, Owensboro	3,000	Owned
<b>Southern Kentucky</b>		
Fairview Office: 1042 Fairview Avenue, Suite A, Bowling Green	3,000	Leased
Campbell Lane Office: 751 Campbell Lane, Bowling Green	7,500	Owned
Glasgow Office: 1006 West Main Street, Glasgow	12,000	Owned
<b>Other Properties</b>		
Office Building: 701 Columbia Avenue, Glasgow	19,000	Owned

**Item 3. Legal Proceedings**

In the normal course of operations, we are defendants in various legal proceedings. We record contingent liabilities resulting from claims against us when a loss is assessed to be probable and the amount of the loss is reasonably estimable. Assessing probability of loss and estimating probable losses requires analysis of multiple factors, including in some cases judgments about the potential actions of third party claimants and courts. Recorded contingent liabilities are based on the best information available and actual losses in any future period are inherently uncertain. In the opinion of management, there is no known legal proceeding pending which an adverse decision would be expected to result in a material adverse change in our business or consolidated financial position. See Footnote 24, "Contingencies" in the Notes to our consolidated financial statements for additional detail regarding ongoing legal proceedings and other matters.

**Item 4. Mine Safety Disclosures**

Not applicable.

## PART II

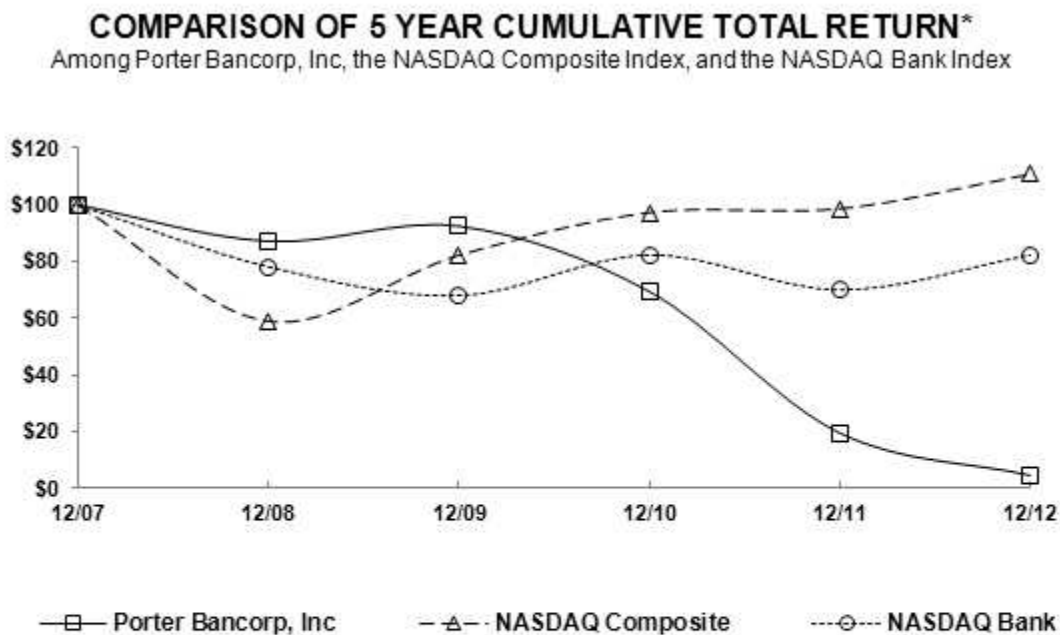
### Item 5. Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

#### Market Information

Our common stock is traded on the NASDAQ Global Market under the ticker symbol “PBIB”. The following table presents the high and low sales prices for our common stock reported on the NASDAQ Global Market for the periods indicated. Market prices and dividends paid have been restated to reflect stock dividends.

Quarter Ended	2012					
	Market Value					
	<u>High</u>		<u>Low</u>		<u>Dividend</u>	
Fourth Quarter	\$ 1.99		\$ 0.70		\$ 0.00	
Third Quarter	2.25		1.48		0.00	
Second Quarter	2.40		1.50		0.00	
First Quarter	3.05		1.69		0.00	
Quarter Ended	2011					
	Market Value					
	<u>High</u>		<u>Low</u>		<u>Dividend</u>	
Fourth Quarter	\$ 3.50		\$ 1.95		\$ 0.00	
Third Quarter	5.01		2.96		0.00	
Second Quarter	8.17		4.72		0.01	
First Quarter	10.72		7.89		0.01	

As of January 31, 2013, we had approximately 1,021 shareholders, including 361 shareholders of record and approximately 660 beneficial owners whose shares are held in “street” name by securities broker-dealers or other nominees.



\*\$100 invested on 12/31/07 in stock or index, including reinvestment of dividends.  
Fiscal year ending December 31.

## **Dividends**

We will not be able to pay dividends on our common stock for the foreseeable future. We historically paid quarterly cash dividends on our common stock until we suspended dividend payments in October 2011.

As a bank holding company, Porter Bancorp's ability to declare and pay dividends depends on certain federal regulatory considerations, including the guidelines of the Federal Reserve regarding capital adequacy and dividends. Porter Bancorp has agreed with the Federal Reserve to obtain its written consent prior to declaring or paying any future dividends.

Our principal source of revenue with which to pay dividends on our common stock is the dividends that PBI Bank may declare and pay to us out of funds legally available for payment of dividends. PBI Bank must obtain the prior written consent of its primary regulators prior to declaring or paying any future dividends. In addition to this current restriction, various laws applicable to PBI Bank also limit its payment of dividends to us. A Kentucky chartered bank may declare a dividend of an amount of the bank's net profits as the board deems appropriate. The approval of the KDFI is required if the total of all dividends declared by the bank in any calendar year exceeds the total of its net profits for that year combined with its retained net profits for the preceding two years, less any required transfers to surplus or a fund for the retirement of preferred stock or debt. As a practical matter, PBI Bank will not be able to pay dividends to us for the foreseeable future.

Effective with the fourth quarter of 2011, we began deferring cash dividends on our Series A preferred stock held by the U.S. Treasury and interest payments on the junior subordinated notes relating to our trust preferred securities. Deferring interest payments on the junior subordinated notes resulted in the deferral of distributions on our trust preferred securities. We will not be able to pay cash dividends on our common stock in the future until we have paid all accrued and unpaid dividends on our Series A preferred stock and all deferred distributions on our trust preferred securities. Dividends on the Series A preferred stock and deferred distributions on our trust preferred securities are cumulative and therefore unpaid dividends and distributions will accrue and compound on each subsequent payment date. If we become subject to any liquidation, dissolution or winding up of affairs, holders of the trust preferred securities and then holders of the preferred stock will be entitled to receive the liquidation amounts to which they are entitled including the amount of any accrued and unpaid distributions and dividends, before any distribution can be made to the holders of our common stock.

## **Purchase of Equity Securities by Issuer**

The Company did not repurchase any shares in 2012.

## Item 6. Selected Financial Data

The following table summarizes our selected historical consolidated financial data from 2008 to 2012. You should read this information in conjunction with Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations" and Item 8. "Financial Statements and Supplementary Data."

### Selected Consolidated Financial Data

(Dollars in thousands except per share data)	As of and for the Years Ended December 31,				
	2012	2011	2010	2009	2008
<b>Income Statement Data:</b>					
Interest income	\$ 57,729	\$ 73,554	\$ 86,407	\$ 94,466	\$ 100,107
Interest expense	15,774	22,039	28,841	40,412	52,881
Net interest income	41,955	51,515	57,566	54,054	47,226
Provision for loan losses	40,250	62,600	30,100	14,200	5,400
Non-interest income	9,590	7,833	11,582	7,094	6,868
Non-interest expense	44,292	104,273	46,478	30,456	27,757
Income (loss) before income taxes	(32,997)	(107,525)	(7,430)	16,492	20,937
Income tax expense (benefit)	(65)	(218)	(3,046)	5,424	6,927
Net income (loss)	(32,932)	(107,307)	(4,384)	11,068	14,010
Less:					
Dividends on preferred stock	(1,750)	(1,750)	(1,810)	(1,750)	(194)
Accretion on Series A preferred stock	(179)	(177)	(177)	(176)	(20)
(Earnings) loss allocated to participating securities	1,429	4,080	184	(97)	(94)
Net income (loss) available to common	\$ (33,432)	\$ (105,154)	\$ (6,187)	\$ 9,045	\$ 13,702
<b>Common Share Data (1):</b>					
Basic earnings (loss) per common share	\$ (2.85)	\$ (8.98)	\$ (0.60)	\$ 1.00	\$ 1.51
Diluted earnings (loss) per common share	(2.85)	(8.98)	(0.60)	1.00	1.51
Cash dividends declared per common share	0.00	0.02	0.49	0.76	0.73
Book value per common share	0.74	3.74	12.76	14.61	14.14
Tangible book value per common share	0.58	3.54	10.33	11.44	11.18
<b>Balance Sheet Data (at period end):</b>					
Total assets	\$ 1,162,631	\$ 1,455,424	\$ 1,723,952	\$ 1,835,090	\$ 1,647,857
Debt obligations:					
FHLB advances	5,604	7,116	15,022	82,980	142,776
Junior subordinated debentures	25,000	25,000	25,000	25,000	25,000
Subordinated capital note	6,975	7,650	8,550	9,000	9,000
<b>Average Balance Data:</b>					
Average assets	\$ 1,341,565	\$ 1,659,959	\$ 1,747,648	\$ 1,714,131	\$ 1,572,599
Average loans	1,033,320	1,243,474	1,353,295	1,371,034	1,324,658
Average deposits	1,217,083	1,434,462	1,459,041	1,385,572	1,250,614
Average FHLB advances	6,325	15,315	47,800	106,259	138,954
Average junior subordinated debentures	25,000	25,000	25,000	25,000	25,000
Average subordinated capital note	7,309	8,208	8,941	9,000	4,525
Average stockholders' equity	75,679	159,434	188,015	168,752	131,706

(1) Common share data has been adjusted to reflect 5% stock dividends effective December 14, 2010, November 19, 2009 and November 10, 2008.

## Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operation

Management's discussion and analysis of financial condition and results of operations analyzes the consolidated financial condition and results of operations of Porter Bancorp, Inc. and its wholly owned subsidiary, PBI Bank. Porter Bancorp, Inc. is a Louisville, Kentucky-based bank holding company which operates 18 full-service banking offices in twelve counties through its wholly-owned subsidiary, PBI Bank. Our markets include metropolitan Louisville in Jefferson County and the surrounding counties of Henry and Bullitt, and extend south along the Interstate 65 corridor to Tennessee. We serve south central Kentucky and southern Kentucky from banking offices in Butler, Green, Hart, Edmonson, Barren, Warren, Ohio, and Daviess Counties. We also have an office in Lexington, the second largest city in Kentucky. The Bank is both a traditional community bank with a wide range of commercial and personal banking products and an online bank which delivers competitive deposit products and services through an on-line banking division operating under the name of Ascencia.

Historically, we have focused on commercial and commercial real estate lending, both in markets where we have banking offices and other growing markets in our region. Commercial, commercial real estate and real estate construction loans accounted for 58.6% of our total loan portfolio as of December 31, 2012, and 60.5% as of December 31, 2011. Commercial lending generally produces higher yields than residential lending, but involves greater risk and requires more rigorous underwriting standards and credit quality monitoring.

### Overview

The following discussion should be read in conjunction with our consolidated financial statements and accompanying notes and other schedules presented elsewhere in the report.

For the year ended December 31, 2012, we reported a net loss of \$32.9 million compared with net loss of \$107.3 million for the year ended December 31, 2011. After deductions for dividends on preferred stock, accretion on preferred stock, and allocating losses to participating securities, the net loss to common shareholders was \$33.4 million for the year ended December 31, 2012, compared with net loss to common shareholders of \$105.2 million for the year ended December 31, 2011. Basic and diluted loss per common share were \$(2.85) for the year ended December 31, 2012, compared with loss per common share of \$(8.98) for 2011.

Our financial performance in 2012 continued to be negatively impacted by the Bank's high level of nonperforming loans and other real estate owned. Asset quality remediation, capital restoration, and lowering the risk profile of the Company are our major objectives for 2013.

Non-performing loans were 10.52% of total loans, and nonperforming assets stood at 11.89% of total assets at December 31, 2012. We remain diligent in the management of our portfolio and are striving to improve credit quality by working throughout our markets with our clients to balance selective new customer acquisition, customer service for our existing clients and prudent risk management.

Significant developments for the year ended December 31, 2012 were:

- John T. Taylor joined the management team in July as President of Porter Bancorp and CEO of PBI Bank. Mr. Taylor is a seasoned banking veteran with deep and broad experience in our Kentucky markets, community banking, and problem asset resolution. Additionally, John R. Davis joined the management team in August and was appointed Chief Credit Officer of PBI Bank with responsibility for establishing and executing the credit quality policies and overseeing credit administration for the organization.
- In October 2012, PBI Bank entered into a new Consent Order with the FDIC and KDFI. Under the new order, the Bank agreed to maintain the capital levels required by the June 2011 order and also agreed should the capital levels not be reached, and if directed in writing by the FDIC, the Bank would develop a plan to immediately raise sufficient capital, or to sell or merge itself into another FDIC insured institution. The new Consent Order also requires the Bank to continue to adhere to the plans implemented in response to the June 2011 Consent Order, and includes the substantive provisions of the June 2011 order.
- In order to comply with the capital requirements of the Consent Order, management and the Board of Directors are evaluating appropriate strategies for increasing the Company's capital. These include, among other things, a possible public offering or private placement of common stock to new and existing shareholders. We have engaged Sandler O'Neill & Partners, LP to act as our financial advisor and to assist our Board in this evaluation and to assist in evaluating our options for the redemption of our Series A preferred stock issued to the US Treasury in 2008 under the Capital Purchase Program.

- Total assets decreased 20.1% to \$1.2 billion at December 31, 2012 compared with \$1.5 billion at the 2011 year-end.
- Loans decreased 20.9% to \$899.1 million compared with \$1.1 billion at December 31, 2011.
- Deposits declined 19.5% to \$1.1 billion compared with \$1.3 billion at December 31, 2011. Certificate of deposit balances declined \$263.8 million to \$760.6 million at December 31, 2012, from \$1.0 billion at December 31, 2011. Loan proceeds received from the repayment of our commercial real estate and construction and development loans were used primarily to redeem maturing certificates of deposit during the year. Demand deposits increased 2.9% to \$114.3 million during 2012 compared with \$111.1 million at December 31, 2011.
- Net interest margin decreased to 3.31% for 2012 compared with 3.40% for 2011. The decrease in margin between periods was due primarily to a reduction in interest earning assets, primarily loans, coupled with lower rates on those assets and elevated non-accrual loan levels. Average loans decreased 16.9% to \$1.0 billion in 2012 compared with \$1.2 billion in 2011.
- Non-performing loans increased \$1.2 million to \$94.6 million at December 31, 2012, compared with \$93.4 million at December 31, 2011. The increase was primarily in the commercial real estate segment of our portfolio, partially offset by decreases in the construction and development, and 1-4 family residential real estate segments. Non-performing assets increased from \$134.8 million at December 31, 2011, to \$138.3 million at December 31, 2012.
- Provision for loan losses decreased \$22.4 million in 2012 compared with 2011 as the result of shrinking the loan portfolio and lower net loan charge-offs of \$36.1 million, or 3.50% of average loans for 2012, compared with \$44.3 million, or 3.56% of average loans for 2011. Although lower than the prior year, our provision for loan losses was elevated in 2012 by a strategy change during the third quarter of 2012 related to classified loans which we expect to more quickly remediate by litigation or foreclosure. For loans subject to this expectation, we applied an additional fair value discount ranging from 10% to 33% to the underlying collateral in our impairment analysis estimates as resolution of this nature generally results in receiving lower values for real estate collateral in a more aggressive sales environment. This resulted in a provision for loan loss of approximately \$5.1 million related to these loans. Additionally, the provision for loan losses was negatively impacted by the high level of loan charge-offs in our historical loss experience factors, which we use to estimate the general component of our allowance for loan losses as well as additional downgrades within the loan portfolio.
- We continue to execute on our strategy to reduce our commercial real estate and construction and development loans. We reduced construction and development loans by \$31.2 million to \$70.3 million, or 82% of total risk-based capital, at December 31, 2012 compared with \$101.5 million, or 85% of total risk-based capital, at December 31, 2011. Non-owner occupied commercial real estate loans, construction and development loans, and multi-family residential real estate loans as a group were reduced by \$103.5 million to \$311.1 million, or 362% of total risk-based capital, at December 31, 2012 compared with \$414.6 million, or 349% of total risk-based capital, at December 31, 2011.
- Loans past due 30-59 days increased from \$17.3 million at December 31, 2011 to \$38.2 million at December 31, 2012 and loans past due 60-89 days increased from \$3.9 million at December 31, 2011, to \$20.3 million at December 31, 2012. These increases were primarily in the commercial real estate, construction and development, and multi-family residential real estate segments of our portfolio.
- Foreclosed properties were \$43.7 million at December 31, 2012, compared with \$41.4 million at December 31, 2011. The Company acquired \$33.5 million of OREO and sold \$24.2 million of OREO during 2012. In addition, fair value write-downs of \$7.7 million were recorded during 2012 to reflect declining values as evidenced by new appraisals and reduced marketing prices in connection with our sales strategies. Our ratio of non-performing assets to total assets increased to 11.9% at December 31, 2012, compared with 9.3% at December 31, 2011.

These items are discussed in further detail throughout this “Management’s Discussion and Analysis of Financial Condition and Results of Operations” Section.

### **Going Concern Considerations and Future Plans**

The consolidated financial statements have been prepared on a going concern basis, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business for the foreseeable future. However, the events and circumstances described in this discussion create an uncertainty about the Company’s ability to continue as a going concern.

For the year ended December 31, 2012, we reported net loss to common shareholders of \$33.4 million. This loss was attributable primarily to \$40.3 million of provision for loan losses expense due to continued decline in credit trends in our portfolio that resulted in net charge-offs of \$36.1 million, OREO expense of \$10.5 million resulting from fair value write-downs driven by new appraisals and reduced marketing prices, net loss on sales, and ongoing operating expense. We also had lower net interest margin due to lower average loans outstanding, loans repricing at lower rates, and the level of non-performing loans in our portfolio. Net loss to common shareholders of \$33.4 million, for the year ended December 31, 2012, compares with net loss to common shareholders of \$105.2 million for year ended December 31, 2011.

During the year ended December 31, 2011, we recorded a net loss to common shareholders of \$105.2 million. This loss was attributable to a \$23.8 million goodwill impairment charge, the establishment of a \$31.7 million valuation allowance on our deferred tax assets, OREO expense of \$47.5 million related to valuation adjustments reflecting our change in strategy related to certain OREO properties, fair value write-downs related to new appraisals received for properties in the portfolio during 2011, net loss on the sale of OREO properties, and increase in carrying costs associated with carrying these higher levels of assets. We also recorded a provision for loan losses expense of \$62.6 million due to the continued decline in credit trends within our portfolio.

In June 2011, the Bank entered into a Consent Order with the FDIC and KDFI in which the Bank agreed, among other things, to improve asset quality, reduce loan concentrations, and maintain a minimum Tier 1 leverage ratio of 9% and a minimum total risk based capital ratio of 12%. The Consent Order was included in our Current Report on 8-K filed on June 30, 2011. In October 2012, the Bank entered into a new Consent Order with the FDIC and KDFI, again agreeing to maintain a minimum Tier 1 leverage ratio of 9% and a minimum total risk based capital ratio of 12%. The Bank also agreed that if it should be unable to reach the required capital levels, and if directed in writing by the FDIC, then the Bank would within 30 days develop, adopt and implement a written plan to sell or merge itself into another federally insured financial institution or otherwise immediately obtain a sufficient capital investment into the Bank to fully meet the capital requirements.

We expect to continue to work with our regulators toward capital ratio compliance as outlined in the written capital plan submitted by the Bank in December 2012. The new Consent Order also requires the Bank to continue to adhere to the plans implemented in response to the June 2011 Consent Order, and includes the substantive provisions of the June 2011 Consent Order. The new Consent Order was included in our Current Report on 8-K filed on September 19, 2012. As of December 31, 2012, the capital ratios required by the Consent Order were not met.

In order to meet these capital requirements, the Board of Directors and management are continuing to evaluate strategies to achieve the following objectives:

- Increasing capital through a possible public offering or private placement of common stock to new and existing shareholders. We have engaged Sandler O'Neill & Partners, LP to act as our financial advisor and to assist our Board in this evaluation and to assist in evaluating our options for the redemption of our Series A preferred stock issued to the US Treasury in 2008 under the Capital Purchase Program.
- Continuing to operate the Company and Bank in a safe and sound manner. This strategy will require us to reduce our lending concentrations, remediate non-performing loans, and reduce other noninterest expense through the disposition of OREO.
- Continuing with succession planning and adding resources to the management team. John T. Taylor was named President and CEO for PBI Bank and appointed to our board of directors in July 2012. Additionally, John R. Davis was appointed Chief Credit Officer of PBI Bank in August 2012, with responsibility for establishing and executing the credit quality policies and overseeing credit administration for the organization.
- Evaluating our internal processes and procedures, distribution of labor, and work-flow to ensure we have adequately and appropriately deployed resources in an efficient manner in the current environment. To this end, we believe the opportunity exists for the centralization of key processes which will lead to improved execution and cost savings.
- Executing on our commitment to improve credit quality and reduce loan concentrations and balance sheet risk.
  - o We have reduced the size of our loan portfolio significantly from \$1.3 billion at December 31, 2010 to \$1.1 billion at December 31, 2011, and \$899.1 million at December 31, 2012. We have significantly improved our staffing in the commercial lending area which is now led by John R. Davis, who joined the management team in August 2012 and now serves as Chief Credit Officer.



- o Our Consent Order calls for us to reduce our construction and development loans to not more than 75% of total risk-based capital. We were not in compliance at December 31, 2012 with construction and development loans representing 82% of total risk-based capital. These loans totaled \$70.3 million, or 82% of total risk-based capital, at December 31, 2012 and \$101.5 million, or 85% of total risk-based capital, at December 31, 2011.
- o Our Consent Order also requires us to reduce non-owner occupied commercial real estate loans, construction and development loans, and multi-family residential real estate loans as a group, to not more than 250% of total risk-based capital. While we have made significant improvements over the last year, we were not in compliance with this concentration limit at December 31, 2012. These loans totaled \$311.1 million, or 362% of total risk-based capital, at December 31, 2012 compared with \$414.6 million, or 349% of total risk-based capital, at December 31, 2011.
- o We are working to reduce non-owner occupied commercial real estate loans, construction and development loans, and multi-family residential real estate loans by curtailing new construction and development lending and new non-owner occupied commercial real estate lending. We are also receiving principal reductions from amortizing credits and pay-downs from our customers who sell properties built for resale. We have reduced the construction loan portfolio from \$199.5 million at December 31, 2010 to \$70.3 million at December 31, 2012. Our non-owner occupied commercial real estate loans declined from \$293.3 million at December 31, 2010 to \$189.8 million at December 31, 2012.
- Executing on our commitment to sell other real estate owned and reinvest in quality income producing assets.
  - o The remediation process for loans secured by real estate has led the Bank to acquire significant levels of OREO in 2012, 2011, and 2010. The Bank acquired \$33.5 million, \$41.9 million, and \$90.8 million of OREO during 2012, 2011, and 2010, respectively.
  - o We have incurred significant losses in disposing of OREO. We incurred losses totaling \$9.3 million, \$42.8 million, and \$13.9 million in 2012, 2011, and 2010, respectively, from sales and fair value write-downs attributable to declining valuations as evidenced by new appraisals and from changes in our sales strategies.
  - o To ensure that we maximize the value we receive upon the sale of OREO, we continue to evaluate sales opportunities and channels. We are targeting multiple sales opportunities and channels through internal marketing and the use of brokers, auctions, and technology sales platforms. Proceeds from the sale of OREO totaled \$22.5 million during 2012, \$26.0 in 2011, and \$25.0 million in 2010.
  - o At December 31, 2011, the OREO portfolio consisted of 75% construction, development, and land assets. At December 31, 2012, this concentration had declined to 51%. This is consistent with our reduction of construction, development and other land loans, which have declined to \$70.3 million at December 31, 2012, compared to \$101.5 million at December 31, 2011. Over the past year, the composition of our OREO portfolio has shifted to be more heavily weighted towards commercial real estate properties with a cash flow opportunity and 1-4 family residential properties, which we have found to be more liquid than construction, development, and land assets. Commercial real estate properties represent 35% of the OREO portfolio at December 31, 2012, compared with 15% at December 31, 2011. 1-4 family residential properties represent 12% of the OREO portfolio at December 31, 2012, compared with 7% at December 31, 2011.
- Evaluating other strategic alternatives, such as the sale of assets or branches.

Bank regulatory agencies can exercise discretion when an institution does not meet the terms of a consent order. Based on individual circumstances, the agencies may issue mandatory directives, impose monetary penalties, initiate changes in management, or take more serious adverse actions.

These financial statements do not include any adjustments that may result should the Company be unable to continue as a going concern.

## Application of Critical Accounting Policies

Our accounting and reporting policies comply with GAAP and conform to general practices within the banking industry. We believe that of our significant accounting policies, the following may involve a higher degree of management assumptions and judgments that could result in materially different amounts to be reported if conditions or underlying circumstances were to change.

**Allowance for Loan Losses** – PBI Bank maintains an allowance for loan losses believed to be sufficient to absorb probable incurred credit losses existing in the loan portfolio, and the board of directors evaluates the adequacy of the allowance for loan losses on a quarterly basis. We evaluate the adequacy of the allowance using, among other things, historical loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of the underlying collateral and current economic conditions and trends. The allowance may be allocated for specific loans or loan categories, but the entire allowance is available for any loan that, in management's judgment, should be charged off. The allowance consists of specific and general components. The specific component relates to loans that are individually classified as impaired. The general component is based on historical loss experience adjusted for environmental factors. We develop allowance estimates based on actual loss experience adjusted for current economic conditions and trends. Allowance estimates are a prudent measurement of the risk in the loan portfolio which we apply to individual loans based on loan type. If the mix and amount of future charge-off percentages differ significantly from those assumptions used by management in making its determination, we may be required to materially increase our allowance for loan losses and provision for loan losses, which could adversely affect our results.

**Other Real Estate Owned** – Other real estate owned (OREO) is real estate acquired as a result of foreclosure or by deed in lieu of foreclosure. It is classified as real estate owned until such time as it is sold. When property is acquired as a result of foreclosure or by deed in lieu of foreclosure, it is recorded at its fair market value less estimated cost to sell. Any write-down of the property at the time of acquisition is charged to the allowance for loan losses. Subsequent reductions in fair value are recorded as non-interest expense. To determine the fair value of OREO for smaller dollar single family homes, we consult with internal real estate sales staff and external realtors, investors, and appraisers. If the internally evaluated market price is below our underlying investment in the property, appropriate write-downs are recorded. For larger dollar commercial real estate properties, we obtain a new appraisal of the subject property in connection with the transfer to other real estate owned. We do not obtain updated appraisals on a quarterly basis after the receipt of the initial appraisal. Rather, we internally review the fair value of the other real estate owned in our portfolio on a quarterly basis to determine if a new appraisal is warranted based on the specific circumstances of each property. We obtain updated appraisals each year on the anniversary of ownership unless a sale is imminent.

**Goodwill and Intangible Assets** – We evaluate goodwill and intangible assets that have indefinite useful lives for impairment at least annually and more frequently if circumstances indicate their value may not be recoverable. We evaluate goodwill for impairment by comparing the fair value of the reporting unit to the book value of the reporting unit. If the fair value, net of goodwill, exceeds book value, then goodwill is not considered to be impaired. We evaluated goodwill for impairment during the second quarter of 2011 because our common stock, which trades publicly on the NASDAQ, experienced a significant drop in value throughout the months of May and June 2011. Our stock trended downward during the first quarter of 2011 and continued downward throughout the months of May and June 2011. The stock closed on June 30, 2011 at \$4.98 per share and has regularly traded at a market price less than book value per common share since the second quarter of 2010.

We evaluated the potential negative impact on the value of our common stock from being removed from the Russell 3000 Index during June 2011, the trend of lower earnings in 2011 compared to historical performance due to the continuing impact on earnings from loan loss provisions, non-performing loans, and foreclosed properties, and recent regulatory agreements entered into by the Company. Our goodwill impairment testing completed during the fourth quarter of 2010 included, among other things, future projections of earnings at levels exceeding actual results for 2011. The level of loan loss provisions and the cost of foreclosed properties continue to exceed our prior expectations as we work through issues with our non-performing loan levels and other real estate owned portfolio.

The fair value of our goodwill was determined utilizing our market capitalization based upon recent common stock price levels. We also considered market comparison transactions and control premiums for institutions of a similar size and performance. Based on this analysis, we determined that our goodwill was impaired and recorded an impairment charge of \$23.8 million in the quarter ended June 30, 2011. The impairment charge had no impact on the Company's liquidity, cash flows, or regulatory capital ratios.

Intangible assets that are not amortized are evaluated for impairment at least annually by comparing the fair values of those assets to their carrying values. Other identifiable intangible assets that are subject to amortization are amortized on an accelerated basis over the years expected to be benefited, which we believe is 10 years. We review these amortizable intangible assets for impairment if circumstances indicate their value may not be recoverable based on a comparison of fair value to carrying value. Based on our annual review, management does not believe our intangible assets are impaired at December 31, 2012.

**Stock-based Compensation** – Compensation cost is recognized for stock options and restricted stock awards issued to employees, based on the fair value of these awards at the date of grant. We utilize a Black-Scholes model, which requires the input of highly subjective assumptions, such as volatility, risk-free interest rates and dividend pay-out rates, to estimate the fair value of stock options, while the market price of the Company’s common stock at the date of grant is used for restricted stock awards. Compensation cost is recognized over the required service period, generally defined as the vesting period. For awards with graded vesting, compensation cost is recognized on a straight-line basis over the requisite service period for the entire award.

**Valuation of Deferred Tax Asset** – We evaluate deferred tax assets for impairment on a quarterly basis. We established a 100% deferred tax valuation allowance of \$31.7 million in December 2011 based upon the analysis of our past performance and our expected future performance.

We considered all evidence currently available, both positive and negative, in determining, based on the weight of that evidence, the likelihood that the deferred tax asset would be realized. During that review, we determined that the level of our recent historical losses, the level of our non-performing assets, our inability to meet our forecasted levels of earnings in 2011, our intent to defer payment of dividends on our subordinated debentures and Series A Preferred Stock, and our non-compliance with the capital requirements of our Consent Order outweighed our forecasted taxable earnings levels for the near and long term. As such, we established a 100% deferred tax valuation allowance. When evaluating our deferred tax assets for realizability during 2012, we concluded that a full valuation allowance was still necessary at December 31, 2012, due to the additional losses incurred during the year. A return to profitability would enable us to reduce the valuation allowance and thereby offset income tax expense that would otherwise be recognized. Examinations of our income tax returns or changes in tax law may impact our deferred tax assets and liabilities as well as our provision for income taxes.

**Contingencies** – In the normal course of operations, we are defendants in various legal proceedings. We record contingent liabilities resulting from claims against us when a loss is assessed to be probable and the amount of the loss is reasonably estimable. Assessing probability of loss and estimating probable losses requires analysis of multiple factors, including in some cases judgments about the potential actions of third party claimants and courts. Recorded contingent liabilities are based on the best information available and actual losses in any future period are inherently uncertain.

## Results of Operations

The following table summarizes components of income and expense and the change in those components for 2012 compared with 2011:

	<b>For the</b>		<b>Change from Prior Period</b>	
	<b>Years Ended December 31,</b>	<b>2011</b>	<b>Amount</b>	<b>Percent</b>
	<b>2012</b>	<b>2011</b>	<b>(dollars in thousands)</b>	
Gross interest income	\$ 57,729	\$ 73,554	\$ (15,825)	(21.5)%
Gross interest expense	15,774	22,039	(6,265)	(28.4)
Net interest income	41,955	51,515	(9,560)	(18.6)
Provision for credit losses	40,250	62,600	(22,350)	(35.7)
Non-interest income	6,354	6,766	(412)	(6.1)
Gains on sale of securities, net	3,236	1,108	2,128	192.1
Other than temporary impairment on securities	—	(41)	41	(100.0)
Non-interest expense	44,292	104,273	(59,981)	(57.5)
Net income (loss) before taxes	(32,997)	(107,525)	74,528	(69.3)
Income tax expense (benefit)	(65)	(218)	153	(70.2)
Net income (loss)	(32,932)	(107,307)	74,375	(69.3)
Dividends on preferred stock	(1,750)	(1,750)	—	—
Accretion on Series A preferred stock	(179)	(177)	(2)	1.1
Earnings allocated to participating securities	1,429	4,080	(2,651)	(65.0)
Net income (loss) available to common shareholders	(33,432)	(105,154)	71,722	(68.2)

Net loss of \$32.9 million for the year ended December 31, 2012, decreased \$74.4 million from net loss of \$107.3 million for 2011. Net loss to common shareholders of \$33.4 million for the year ended December 31, 2012, decreased \$71.7 million from net loss to common shareholders of \$105.2 million for 2011. This decrease in net loss was attributable primarily to lower provision for loan losses expense, decreased non-interest expense associated with our OREO, and higher net gain on sales of securities, partially offset by lower net interest income. In addition, the 2011 results included a one-time goodwill impairment charge of \$23.8 million.

The following table summarizes components of income and expense and the change in those components for 2011 compared with 2010:

	<b>For the</b>		<b>Change from Prior Period</b>	
	<b>Years Ended December 31,</b>	<b>2010</b>	<b>Amount</b>	<b>Percent</b>
	<b>2011</b>	<b>2010</b>	<b>(dollars in thousands)</b>	
Gross interest income	\$ 73,554	\$ 86,407	\$ (12,853)	(14.9)%
Gross interest expense	22,039	28,841	(6,802)	(23.6)
Net interest income	51,515	57,566	(6,051)	(10.5)
Provision for credit losses	62,600	30,100	32,500	108.0
Non-interest income	6,766	7,027	(261)	(3.7)
Gains on sale of securities, net	1,108	5,152	(4,044)	(78.5)
Other than temporary impairment on securities	(41)	(597)	556	(93.1)
Non-interest expense	104,273	46,478	57,795	124.3
Net income (loss) before taxes	(107,525)	(7,430)	(100,095)	1347.2
Income tax expense (benefit)	(218)	(3,046)	2,828	(92.8)
Net income (loss)	(107,307)	(4,384)	(102,923)	2347.7
Dividends on preferred stock	(1,750)	(1,810)	60	(3.3)
Accretion on Series A preferred stock	(177)	(177)	—	—
Earnings allocated to participating securities	4,080	184	3,896	2117.4
Net income (loss) available to common shareholders	(105,154)	(6,187)	(98,967)	1599.6

Net loss of \$107.3 million for the year ended December 31, 2011, increased \$102.9 million from net loss of \$4.4 million for 2010. Net loss to common shareholders of \$105.2 million for the year ended December 31, 2011, increased \$99.0 million from net loss to common shareholders of \$6.2 million for 2010. This decrease in earnings was attributable primarily to a one-time goodwill impairment charge of \$23.8 million, establishment of a deferred tax asset valuation allowance of \$31.7 million, increased provision for loan losses expense, and non-interest expenses associated with our OREO.

Goodwill was determined to be impaired during the second quarter of 2011 as the result of operating losses and a significant drop in value of our common stock which trades on NASDAQ. The deferred tax asset is dependent on future levels of income. Given our net loss for the past two years, and evaluation of other positive and negative evidence, we established a 100% valuation allowance for our deferred tax asset in the fourth quarter of 2011. Provision for loan losses expense increased \$32.5 million, or 108.0%, in comparison with 2010 as a result of an increase in non-performing loans, and an increase in net loan charge-offs to \$44.3 million, or 3.56% of average loans for 2011, compared with \$22.2 million, or 1.64% of average loans for 2010. Non-interest income decreased \$261,000, or 3.7%, in comparison with 2010 primarily as a result of decreased service charges on deposit accounts. Gains on sales of investment securities decreased \$4.0 million, or 78.5% in comparison with 2010 due to fewer sales of securities during the year.

Non-interest expense increased \$57.8 million, or 124.3%, in comparison with 2010 primarily as a result of a one-time goodwill impairment charge of \$23.8 million, increased expense related to other real estate owned, increased loan collection expense, and borrowing prepayment fees. Income tax benefit decreased \$2.8 million, or 92.8%, as the result of the establishment of the \$31.7 million deferred tax valuation allowance.

**Net Interest Income** – Our net interest income was \$42.0 million for the year ended December 31, 2012, a decrease of \$9.6 million, or 18.6%, compared with \$51.5 million for the same period in 2011. Net interest spread and margin were 3.16% and 3.31%, respectively, for 2012, compared with 3.24% and 3.40%, respectively, for 2011. Average nonaccrual loans were \$90.8 million and \$67.4 million in 2012 and 2011, respectively. The decrease in net interest income was primarily the result of lower average earning assets coupled with lower rates on those assets. In addition, net interest income and net interest margin were adversely affected by \$4.9 million and \$4.0 million of interest lost on non-accrual loans during 2012 and 2011, respectively.

Our average interest-earning assets were \$1.28 billion for 2012, compared with \$1.53 billion for 2011, a 16.5% decrease, primarily attributable to lower average loans and interest bearing deposits with financial institutions, partially offset by higher average investment securities. Average loans were \$1.03 billion for 2012, compared with \$1.24 billion for 2011, a 16.9% decrease. Average interest bearing deposits with financial institutions were \$62.1 million in 2012, compared with \$127.1 million in 2011, a 51.1% decrease. Average investment securities were \$173.1 million for 2012, compared with \$148.5 million for 2011, a 16.6% increase. Our total interest income decreased 21.5% to \$57.7 million for 2012, compared with \$73.6 million for 2011. The change was due primarily to lower interest rates on and lower volume of loans and interest bearing deposits with financial institutions, and lower interest rates on investment securities.

Our average interest-bearing liabilities decreased by 17.5% to \$1.14 billion for 2012, compared with \$1.39 billion for 2011. Our total interest expense decreased by 28.4% to \$15.8 million for 2012, compared with \$22.0 million during 2011, due primarily to lower interest rates paid on and lower volume of certificates of deposit, NOW and money market deposits. Our average volume of certificates of deposit decreased 18.6% to \$912.1 million for 2012, compared with \$1.12 billion for 2011. The average interest rate paid on certificates of deposit decreased to 1.52% for 2012, compared with 1.65% for 2011, as the result of continued re-pricing of certificates of deposit at maturity to lower interest rates. Our average volume of NOW and money market deposit accounts decreased 10.5% to \$153.0 million for 2012, compared with \$171.0 million for 2011. The average interest rate paid on NOW and money market deposit accounts decreased to 0.42% for 2012, compared with 0.85% for 2011.

Our net interest income was \$51.5 million for the year ended December 31, 2011, a decrease of \$6.1 million, or 10.5%, compared with \$57.6 million for the same period in 2010. Net interest spread and margin were 3.24% and 3.40%, respectively, for 2011, compared with 3.38% and 3.59%, respectively, for 2010. Average nonaccrual loans were \$67.4 million and \$54.0 million in 2011 and 2010, respectively. The decrease in net interest income was primarily the result of lower average earning assets. In addition, net interest income and net interest margin were adversely affected by \$4.0 million and \$2.7 million of interest lost on non-accrual loans during 2011 and 2010, respectively. Also, average interest bearing liabilities as a percentage of interest earning assets increased from 89.6% in 2010 to 90.3% in 2011 due to lower capital. Nonaccrual loans increased significantly in the fourth quarter of 2011.

Our average interest-earning assets were \$1.53 billion for 2011, compared with \$1.62 billion for 2010, a 5.2% decrease, primarily attributable to lower average loans and investment securities. Average loans were \$1.24 billion for 2011, compared with \$1.35 billion for 2010, an 8.1% decrease. Average investment securities were \$148.5 million for 2011, compared with \$159.9 million for 2010, a 7.1% decrease. Our total interest income decreased 14.9% to \$73.6 million for 2011, compared with \$86.4 million for 2010. The change was due primarily to lower interest rates on and lower volume of loans and investment securities.

Our average interest-bearing liabilities decreased by 4.4% to \$1.39 billion for 2011, compared with \$1.45 billion for 2010. Our total interest expense decreased by 23.6% to \$22.0 million for 2011, compared with \$28.8 million during 2010, due primarily to lower interest rates paid on certificates of deposit, and a lower volume of FHLB advances. Our average volume of certificates of deposit decreased 3.2% to \$1.12 billion for 2011, compared with \$1.16 billion for 2010. The average interest rate paid on certificates of deposit decreased to 1.65% for 2011, compared with 2.02% for 2010. Our average volume of FHLB advances decreased 68.0% to \$15.3 million for 2011, compared with \$47.8 million for 2010. The average interest rate paid on FHLB advances decreased to 3.51% for 2011, compared with 4.22% for 2010. The decrease in cost of funds was the result of the continued re-pricing of certificates of deposit at maturity at lower interest rates.

## Average Balance Sheets

The following table sets forth the average daily balances, the interest earned or paid on such amounts, and the weighted average yield on interest-earning assets and weighted average cost of interest-bearing liabilities for the periods indicated. Dividing income or expense by the average daily balance of assets or liabilities, respectively, derives such yields and costs for the periods presented.

	For the Years Ended December 31,					
	2012			2011		
	Average Balance	Interest Earned/Paid	Average Yield/Cost	Average Balance	Interest Earned/Paid	Average Yield/Cost
	(dollars in thousands)					
<b>ASSETS</b>						
Interest-earning assets:						
Loans receivables (1)(2)						
Real estate	\$ 921,314	\$ 46,179	5.01%	\$ 1,111,136	\$ 59,450	5.35%
Commercial	64,252	3,510	5.46	77,098	4,362	5.66
Consumer	22,720	1,903	8.38	29,140	2,428	8.33
Agriculture	24,196	1,304	5.39	25,175	1,407	5.59
Other	838	22	2.63	925	32	3.46
U.S. Treasury and agencies	6,588	199	3.02	10,173	322	3.17
Mortgage-backed securities	111,637	1,986	1.78	96,221	2,967	3.08
State and political subdivision securities (3)	26,631	887	5.12	29,506	1,123	5.86
State and political subdivision securities	17,363	563	3.24	3,178	172	5.41
Corporate bonds	8,957	482	5.38	7,466	452	6.05
FHLB stock	10,072	447	4.44	10,072	428	4.25
Other debt securities	572	46	8.04	572	46	8.04
Other equity securities	1,359	57	4.19	1,397	49	3.51
Federal funds sold	3,109	2	0.06	5,729	3	0.05
Interest-bearing deposits in other financial institutions	62,127	142	0.23	127,087	313	0.25
<b>Total interest-earning assets</b>	<b>1,281,735</b>	<b>57,729</b>	<b>4.54%</b>	<b>1,534,875</b>	<b>73,554</b>	<b>4.83%</b>
Less: Allowance for loan losses	(53,484)			(37,762)		
Non-interest-earning assets	113,314			162,846		
<b>Total assets</b>	<b>\$ 1,341,565</b>			<b>\$ 1,659,959</b>		
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>						
Interest-bearing liabilities						
Certificates of deposit and other time deposits	\$ 912,061	\$ 13,828	1.52%	\$ 1,120,154	\$ 18,468	1.65%
NOW and money market deposits	153,032	641	0.42	171,028	1,451	0.85
Savings accounts	38,665	154	0.40	36,511	228	0.62
Federal funds purchased and repurchase agreements	2,088	7	0.34	10,524	440	4.18
FHLB advances	6,325	207	3.27	15,315	537	3.51
Junior subordinated debentures	32,309	937	2.90	33,208	915	2.76
<b>Total interest-bearing liabilities</b>	<b>1,144,480</b>	<b>15,774</b>	<b>1.38%</b>	<b>1,386,740</b>	<b>22,039</b>	<b>1.59%</b>
Non-interest-bearing liabilities						
Non-interest-bearing deposits	113,325			106,769		
Other liabilities	8,081			7,016		
<b>Total liabilities</b>	<b>1,265,886</b>			<b>1,500,525</b>		
Stockholders' equity	75,679			159,434		
<b>Total liabilities and stockholders' equity</b>	<b>\$ 1,341,565</b>			<b>\$ 1,659,959</b>		
<b>Net interest income</b>		<b>\$ 41,955</b>			<b>\$ 51,515</b>	
<b>Net interest spread</b>			<b>3.16%</b>			<b>3.24%</b>

<b>Net interest margin</b>	<u>3.31%</u>	<u>3.40%</u>
<b>Ratio of average interest-earning assets to average interest-bearing liabilities</b>	<u>111.99%</u>	<u>110.68%</u>

- 
- (1) Includes loan fees in both interest income and the calculation of yield on loans.
  - (2) Calculations include non-accruing loans in average loan amounts outstanding.
  - (3) Taxable equivalent yields are calculated assuming a 35% federal income tax rate.

For the Years Ended December 31,

	2011			2010		
	Average Balance	Interest Earned/Paid	Average Yield/Cost	Average Balance	Interest Earned/Paid	Average Yield/Cost
(dollars in thousands)						
<b>ASSETS</b>						
Interest-earning assets:						
Loans receivables (1)(2)						
Real estate	\$ 1,111,136	\$ 59,450	5.35%	\$ 1,209,125	\$ 67,960	5.62%
Commercial	77,098	4,362	5.66	84,847	5,131	6.05
Consumer	29,140	2,428	8.33	34,346	2,944	8.57
Agriculture	25,175	1,407	5.59	23,877	1,483	6.21
Other	925	32	3.46	1,100	41	3.73
U.S. Treasury and agencies	10,173	322	3.17	9,674	362	3.74
Mortgage-backed securities	96,221	2,967	3.08	110,718	5,846	5.28
State and political subdivision securities (3)	29,506	1,123	5.86	21,331	854	6.16
State and political subdivision securities	3,178	172	5.41	2,947	161	5.46
Corporate bonds	7,466	452	6.05	12,906	875	6.78
FHLB stock	10,072	428	4.25	10,072	441	4.38
Other debt securities	572	46	8.04	694	46	6.63
Other equity securities	1,397	49	3.51	1,623	48	2.96
Federal funds sold	5,729	3	0.05	12,633	16	0.13
Interest-bearing deposits in other financial institutions	127,087	313	0.25	82,648	199	0.24
<b>Total interest-earning assets</b>	<u>1,534,875</u>	<u>73,554</u>	<u>4.83%</u>	<u>1,618,541</u>	<u>86,407</u>	<u>5.37%</u>
Less: Allowance for loan losses	(37,762)			(27,836)		
Non-interest-earning assets	162,846			156,943		
<b>Total assets</b>	<u>\$ 1,659,959</u>			<u>\$ 1,747,648</u>		
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>						
Interest-bearing liabilities						
Certificates of deposit and other time deposits	\$ 1,120,154	\$ 18,468	1.65%	\$ 1,156,724	\$ 23,415	2.02%
NOW and money market deposits	171,028	1,451	0.85	164,541	1,716	1.04
Savings accounts	36,511	228	0.62	35,393	261	0.74
Federal funds purchased and repurchase agreements	10,524	440	4.18	11,734	484	4.12
FHLB advances	15,315	537	3.51	47,800	2,015	4.22
Junior subordinated debentures	33,208	915	2.76	33,941	950	2.80
<b>Total interest-bearing liabilities</b>	<u>1,386,740</u>	<u>22,039</u>	<u>1.59%</u>	<u>1,450,133</u>	<u>28,841</u>	<u>1.99%</u>
Non-interest-bearing liabilities						
Non-interest-bearing deposits	106,769			102,383		
Other liabilities	7,016			7,117		
<b>Total liabilities</b>	<u>1,500,525</u>			<u>1,559,633</u>		
Stockholders' equity	159,434			188,015		
<b>Total liabilities and stockholders' equity</b>	<u>\$ 1,659,959</u>			<u>\$ 1,747,648</u>		
<b>Net interest income</b>		<u>\$ 51,515</u>			<u>\$ 57,566</u>	
<b>Net interest spread</b>			<u>3.24%</u>			<u>3.38%</u>
<b>Net interest margin</b>			<u>3.40%</u>			<u>3.59%</u>
<b>Ratio of average interest-earning assets to average interest-bearing</b>						



**liabilities**

110.68%

111.61%

- 
- (1) Includes loan fees in both interest income and the calculation of yield on loans.
  - (2) Calculations include non-accruing loans in average loan amounts outstanding.
  - (3) Taxable equivalent yields are calculated assuming a 35% federal income tax rate.

## Rate/Volume Analysis

The table below sets forth information regarding changes in interest income and interest expense for the periods indicated. For each category of interest-earning assets and interest-bearing liabilities, information is provided on changes attributable to (1) changes in rate (changes in rate multiplied by old volume); (2) changes in volume (changes in volume multiplied by old rate); and (3) changes in rate-volume (change in rate multiplied by change in volume). Changes in rate-volume are proportionately allocated between rate and volume variance.

	<u>Year Ended December 31, 2012 vs. 2011</u>			<u>Year Ended December 31, 2011 vs. 2010</u>		
	<u>Increase (decrease)</u>			<u>Increase (decrease)</u>		
	<u>due to change in</u>			<u>due to change in</u>		
	<u>Rate</u>	<u>Volume</u>	<u>Net</u>	<u>Rate</u>	<u>Volume</u>	<u>Net</u>
			<u>Change</u>			<u>Change</u>
	(in thousands)					
<b>Interest-earning assets:</b>						
Loan receivables	\$ (3,824)	\$ (10,937)	\$ (14,761)	\$ (3,782)	\$ (6,098)	\$ (9,880)
U.S. Treasury and agencies	(14)	(109)	(123)	(58)	18	(40)
Mortgage-backed securities	(1,401)	420	(981)	(2,190)	(689)	(2,879)
State and political subdivision securities	(243)	398	155	(55)	335	280
Corporate bonds	(54)	84	30	(86)	(337)	(423)
FHLB stock	19	—	19	(13)	—	(13)
Other debt securities	—	—	—	9	(9)	—
Other equity securities	9	(1)	8	8	(7)	1
Federal funds sold	—	(1)	(1)	(6)	(7)	(13)
Interest-bearing deposits in other financial institutions	(21)	(150)	(171)	5	109	114
<b>Total increase (decrease) in interest income</b>	<u>(5,529)</u>	<u>(10,296)</u>	<u>(15,825)</u>	<u>(6,168)</u>	<u>(6,685)</u>	<u>(12,853)</u>
<b>Interest-bearing liabilities:</b>						
Certificates of deposit and other time deposits	(1,402)	(3,238)	(4,640)	(4,238)	(709)	(4,947)
NOW and money market accounts	(670)	(140)	(810)	(324)	59	(265)
Savings accounts	(86)	12	(74)	(41)	8	(33)
Federal funds purchased and repurchase agreements	(231)	(202)	(433)	7	(51)	(44)
FHLB advances	(34)	(296)	(330)	(293)	(1,185)	(1,478)
Junior subordinated debentures	46	(24)	22	(15)	(20)	(35)
<b>Total increase (decrease) in interest expense</b>	<u>(2,377)</u>	<u>(3,888)</u>	<u>(6,265)</u>	<u>(4,904)</u>	<u>(1,898)</u>	<u>(6,802)</u>
<b>Increase (decrease) in net interest income</b>	<u>\$ (3,152)</u>	<u>\$ (6,408)</u>	<u>\$ (9,560)</u>	<u>\$ (1,264)</u>	<u>\$ (4,787)</u>	<u>\$ (6,051)</u>

**Non-Interest Income** – The following table presents for the periods indicated the major categories of non-interest income:

	<b>For the Years Ended December 31,</b>		
	<b>2012</b>	<b>2011</b>	<b>2010</b>
	<b>(in thousands)</b>		
Service charges on deposit accounts	\$ 2,239	\$ 2,609	\$ 2,984
Income from fiduciary activities	1,177	993	987
Bank card interchange fees	727	668	606
Other real estate owned rental income	420	200	121
Secondary market brokerage fees	94	219	327
Gain on sales of loans originated for sale	338	713	554
Gain on sales of investment securities, net	3,236	1,108	5,152
Other-than-temporary impairment on securities	—	(41)	(597)
Other	1,359	1,364	1,448
Total non-interest income	<u>\$ 9,590</u>	<u>\$ 7,833</u>	<u>\$ 11,582</u>

Non-interest income increased by \$1.8 million to \$9.6 million for 2012 compared with \$7.8 million for 2011. This was due primarily to increased gain on sales of investment securities of \$2.1 million, or 192.1%, due to higher volume of sales. This increase was offset partially by decreased service charges on deposit accounts of \$370,000, or 14.2%, and decreased gain on sales of loans originated for sale of \$375,000, or 52.6%. Fewer service charges on deposit account fees were the result of lower transaction volume. Lower gains on sales of loans originated for sale were the result of fewer loans originated for sale during the year in the USDA and SBA programs.

Non-interest income decreased by \$3.7 million to \$7.8 million for 2011 compared with \$11.6 million for 2010. This was due primarily to lower gain on sales of investment securities of \$4.0 million, or 78.5%, due to fewer sales. Our non-interest income was also lower due to decreased service charges on deposit accounts of \$375,000, or 12.6%, and decreased secondary market brokerage fees of \$108,000, or 33.0%. Fewer service charges on deposit account fees were the result of lower transaction volume. These decreases were offset partially by increased gains on sales of loans originated for sale of \$159,000, or 28.7%, and lower other-than-temporary impairment charges of \$556,000, or 93.1%.

**Non-interest Expense** – The following table presents the major categories of non-interest expense:

	<b>For the Years Ended December 31,</b>		
	<b>2012</b>	<b>2011</b>	<b>2010</b>
	<b>(in thousands)</b>		
Salary and employee benefits	\$ 16,648	\$ 15,218	\$ 14,903
Occupancy and equipment	3,642	3,729	4,095
Goodwill impairment charge	—	23,794	—
Other real estate owned expense	10,549	47,525	16,254
FDIC insurance	2,835	3,470	2,971
Loan collection expense	2,442	2,509	908
State franchise tax	2,174	2,228	2,172
Professional fees	1,985	1,392	1,067
Communications	710	678	737
Borrowing prepayment fees	—	486	—
Postage and delivery	454	485	722
Office supplies	357	352	388
Advertising	154	314	408
Other	2,342	2,093	1,853
Total non-interest expense	<u>\$ 44,292</u>	<u>\$ 104,273</u>	<u>\$ 46,478</u>

Non-interest expense for the year ended December 31, 2012, of \$44.3 million represented a 57.5% decrease from \$104.3 million for the same period last year. The decrease in non-interest expense was attributable primarily to decreased other real estate owned expense due to lower loss on sales of OREO, lower valuation write-downs, and lower property maintenance expenses. Expenses related to other real estate owned include:

	<u>2012</u>	<u>2011</u>
	(in thousands)	
Net loss on sales	\$ 1,672	\$ 8,889
Provision to allowance for sales strategy change	—	25,613
Provision to allowance for declining market values	7,154	9,261
Operating expense	<u>1,723</u>	<u>3,762</u>
Total	<u>\$ 10,549</u>	<u>\$ 47,525</u>

During 2012, we recorded approximately \$7.2 million of provision to allowance for declining market values related to new appraisals received for properties in the portfolio during the year. This compares with \$9.3 million of provision related to new appraisals received for properties in the portfolio during 2011.

In 2011, the Company sold, in a single transaction, 54 finished condominium property units from condominium developments held in our OREO portfolio with a carrying value of approximately \$11.0 million, for \$5.2 million, resulting in a pre-tax loss of \$5.8 million. No similar transaction occurred in 2012.

Although we were carrying our OREO at fair market value less estimated cost to sell in 2011, we subsequently adjusted our valuations for land development and residential development properties held in OREO that were similar to the properties we sold in 2011. We recorded an allowance totaling approximately \$25.6 million to reflect our intent to market these properties more aggressively to retail and bulk buyers. No similar change in sales strategy was implemented during 2012.

FDIC insurance assessments decreased \$635,000, or 18.3%, to \$2.8 million in 2012 from \$3.5 million in 2011 due to decreased deposit levels. Borrowing prepayment fees decreased \$486,000 as no such fees were incurred during 2012. Additionally, non-interest expense for 2011 included a non-recurring 100% goodwill impairment charge of \$23.8 million.

These improvements were offset partially by higher salaries and employee benefits expense of \$1.4 million, or 9.4%, due primarily to additions to staff in our credit administration and workout divisions, and higher professional fees of \$593,000, or 42.6%, due primarily to increased audit and accounting fees, and loan review fees.

#### ***Non-interest Expense Comparison – 2011 to 2010***

Non-interest expense for the year ended December 31, 2011, of \$104.3 million represented a 124.3% increase from \$46.5 million for the same period last year. The increase in non-interest expense was attributable primarily to an increase in other real estate owned expense from increased losses on sales of OREO, OREO write-downs to reflect declining market values and the impact of our sales strategy change in regard to certain OREO properties, and OREO maintenance expenses. Expenses related to other real estate owned include:

	<u>2011</u>	<u>2010</u>
	(in thousands)	
Net loss on sales	\$ 8,889	\$ 565
Provision to allowance for sales strategy change	25,613	—
Provision to allowance for declining market values	9,261	14,062
Operating expense	<u>3,762</u>	<u>1,627</u>
Total	<u>\$ 47,525</u>	<u>\$ 16,254</u>

In 2011, management determined, with the concurrence of the Board of Directors, that certain properties held in OREO were not likely to be successfully disposed of in an acceptable time-frame using routine marketing efforts. It became apparent due to weakness in the economy and softness in demand for housing that certain land development and residential condominium projects would require extended holding periods to sell the properties at recent appraised values. Accordingly, in June of 2011, the Company sold, in a single transaction, 54 finished condominium property units from condominium developments held in our OREO portfolio with a carrying value of approximately \$11.0 million, for \$5.2 million, resulting in a pre-tax loss of \$5.8 million.

Although we were carrying our OREO at fair market value less estimated cost to sell, we subsequently adjusted our valuations for land development and residential development properties held in OREO similar to the properties we sold in 2011. We recorded an allowance totaling approximately \$25.6 million to reflect our intent to market these properties more aggressively to retail and bulk buyers. Additionally, we recorded approximately \$9.3 million of fair value write-downs related to new appraisals received for properties in the portfolio during 2011.

Loan collection expense increased \$1.6 million, or 176.3%, to \$2.5 million in 2011 from \$908,000 in 2010 due to settlements of certain legal matters and increased volume of foreclosures. In June 2011, we settled this litigation for less than the \$1,058,000 minimum amount of compensatory and punitive damages awarded in a jury verdict against PBI Bank, which we recorded in the second quarter as loan collection expense. We also recorded approximately \$300,000 of loan collection expense in 2011 related to a Jefferson County, Kentucky court ruling to uphold a contested mechanics lien on a property for which we took a deed in lieu of foreclosure.

FDIC insurance assessments increased \$499,000, or 16.8%, to \$3.5 million in 2011 from \$3.0 million in 2010 as a result of our non-performing asset levels. Salaries and employee benefits expense increased \$315,000, or 2.1%, to \$15.2 million in 2011 from \$14.9 million in 2010 due to merit raises and increases in staff primarily in the credit and problem asset workout areas. Professional fees increased \$325,000, or 30.5%, to \$1.4 million in 2011 from \$1.1 million in 2010 due to increased accounting and evaluation services related to goodwill impairment and deferred tax assets, and increased staff recruitment services and management evaluation services. We incurred borrowing prepayment fees of \$312,000 on the retirement of a \$10 million repurchase agreement prior to maturity and \$174,000 on the prepayment of \$5.5 million of FHLB advances prior to maturity. We elected to redeem these higher cost borrowings in connection with our asset/liability planning and to lower our cost of funds in future periods. No similar transactions occurred in 2010.

These increases were offset partially by a decrease in occupancy and equipment expense of \$366,000, or 8.9%, due to reduced depreciation on equipment expense, and decreased postage and delivery expense of \$237,000, or 32.8%, due to our decision to replace certain third-party courier services with in-house personnel.

### ***Goodwill Impairment***

The Company evaluates goodwill for impairment annually in the fourth quarter unless events or changes in circumstances indicate potential impairment may have occurred between annual assessments. Goodwill was reviewed for impairment during the second quarter of 2011 because the market price of our common stock on NASDAQ declined. Our stock trended downward during the first quarter of 2011 to a low of \$7.89 per share and continued downward through May and June 2011. The stock closed on June 30, 2011 at \$4.98 per share and has traded at a market price less than book value per common share since the second quarter of 2010. Our market value to book value ratios are noted below.

The ratio at June 30, 2011 is reflected on a pre-goodwill impairment charge basis.

### **Market Value to Book Value Ratio:**

	<u>Book Value Per Share</u>	<u>Market Price Per Share</u>	<u>Market to Book Ratio</u>
12/31/2010	\$ 12.76	\$ 10.31	81%
3/31/2011	\$ 12.79	\$ 7.89	62%
6/30/2011	\$ 9.47	\$ 4.98	53%

We evaluated the potential negative impact of several factors on the value of our common stock, including, being removed from the Russell 3000 Index during June 2011; the trend of lower earnings in 2011 compared to historical performance due to the continuing impact of loan loss provisions, non-performing loans, and foreclosed properties; and our agreements with regulators. Our goodwill impairment testing completed during the fourth quarter of 2010 included, among other things, future projections of earnings at levels exceeding actual results for 2011. The level of loan loss provisions and the cost of foreclosed properties continue to exceed our prior expectations as we work through issues with our non-performing loan levels and other real estate owned portfolio.

We determined the fair value utilizing our market capitalization based upon recent common stock price levels. We also considered market comparison transactions and control premiums for institutions of a similar size and performance. Based on this analysis, we determined that our goodwill was impaired and recorded an impairment charge of \$23.8 million in the quarter ended June 30, 2011. The impairment charge had no impact on the Company's liquidity, cash flows, or regulatory ratios.

**Income Tax Expense** – Income tax benefit was \$65,000 for 2012 compared with \$218,000 for 2011. The 2011 income tax benefit was affected significantly by the establishment of a 100% valuation allowance for our deferred tax asset of \$31.7 million. Our deferred tax valuation allowance increased to \$43.9 million at December 31, 2012. Our statutory federal tax rate was 35% in both 2012 and 2011. The effective tax rate for 2012 and 2011 is not meaningful due to the reduction of income tax benefit as the result of the establishment of the deferred tax valuation allowance.

The valuation allowance for our deferred tax assets does not have any impact on our liquidity, nor does it preclude us from using the tax losses, tax credits or other timing differences in the future. To the extent we generate taxable income in a given quarter, the valuation allowance may be reduced to offset fully or partially the corresponding income tax expense. Any remaining deferred tax asset valuation allowance may be reversed through income tax expense once we can demonstrate a sustainable return to profitability and conclude it is more likely than not the deferred tax asset will be utilized.

See Note 14, "Income Taxes", for additional discussion of our income taxes.

Income tax benefit was \$218,000 for 2011 compared with \$3.0 million for 2010. The 2011 income tax benefit was affected significantly by the establishment of a 100% valuation allowance for our deferred tax asset of \$31.7 million. Our statutory federal tax rate was 35% in both 2011 and 2010. Our effective federal tax rate was 41.0% in 2010. The effective tax rate for 2011 is not meaningful due to the reduction of income tax benefit as the result of the establishment of the deferred tax valuation allowance.

### Analysis of Financial Condition

Total assets at December 31, 2012 were \$1.2 billion compared with \$1.5 billion at December 31, 2011, a decrease of \$292.8 million or 20.1%. This decrease was attributable primarily to a decrease of \$236.9 million in loans. The decrease in loans was attributable to principal reductions by customers outpacing loan originations and advances, as well as \$37.5 million in loan charge-offs and the transfer of loan balances totaling \$33.5 million to OREO.

PBI Bank's total risk-based capital was \$85.8 million at December 31, 2012. PBI Bank's consent order with its primary regulators required its Board of Directors to adopt and implement a plan to reduce its construction and development loans to not more than 75% of total risk-based capital. These loans totaled \$70.3 million, or 82% of total risk-based capital, at December 31, 2012. It also required a plan to reduce non-owner occupied commercial real estate loans, construction and development loans, and multifamily residential real estate loans as a group, to not more than 250% of total risk based capital. These loans totaled \$311.1 million, or 362% of total risk-based capital, at December 31, 2012.

While we have not yet reduced our balances in these categories to the percentages established in our plan, the largest decrease in loans was in our construction loan portfolio, which declined from \$101.5 million at December 31, 2011 to \$70.3 million at December 31, 2012. Our non-owner occupied commercial real estate loans declined from \$252.7 million at December 31, 2011 to \$189.8 million at December 31, 2012.

Total assets at December 31, 2011 were \$1.5 billion compared with \$1.7 billion at December 31, 2010, a decrease of \$268.5 million or 15.6%. This decrease was attributable primarily to a decrease of \$166.6 million in loans. The decrease in loans was attributable to principal reductions by customers outpacing loan originations and advances, as well as \$44.6 million in loan charge-offs and the transfer of loan balances totaling \$41.9 million to OREO.

**Loans Receivable** – Loans receivable decreased \$236.9 million, or 20.9%, during the year ended December 31, 2012, to \$899.1 million. Our commercial, commercial real estate and real estate construction portfolios decreased by an aggregate of \$161.1 million, or 23.4%, during 2012 and comprised 58.6% of the total loan portfolio at December 31, 2012.

Loans receivable decreased \$166.6 million, or 12.8%, to \$1.1 billion at December 31, 2011, compared with \$1.3 billion at December 31, 2010. Our commercial, commercial real estate and real estate construction portfolios decreased \$129.7 million, or 15.9%, to \$687.5 million at December 31, 2011. At December 31, 2011, these loans comprised 60.5% of the total loan portfolio compared with 62.7% of the loan portfolio at December 31, 2010.

**Loan Portfolio Composition** – The following table presents a summary of the loan portfolio at the dates indicated, net of deferred loan fees, by type. There are no foreign loans in our portfolio and other than the categories noted, there is no concentration of loans in any industry exceeding 10% of total loans.

	As of December 31,			
	2012		2011	
	Amount	Percent	Amount	Percent
	(dollars in thousands)			
Commercial	\$ 52,567	5.85%	\$ 71,216	6.27%
Commercial Real Estate:				
Construction	70,284	7.82	101,471	8.93
Farmland	80,825	8.99	90,958	8.01
Other	322,687	35.89	423,844	37.31
Residential Real Estate:				
Multi-family	50,986	5.67	60,410	5.31
1-4 Family	278,273	30.95	337,350	29.70
Consumer	20,383	2.27	26,011	2.29
Agriculture	22,317	2.48	23,770	2.09
Other	770	0.08	993	0.09
Total loans	<u>\$ 899,092</u>	<u>100.00%</u>	<u>\$ 1,136,023</u>	<u>100.00%</u>



	As of December 31,					
	2010		2009		2008	
	Amount	Percent	Amount	Percent	Amount	Percent
	(dollars in thousands)					
Commercial	\$ 90,290	6.93%	\$ 89,903	6.36%	\$ 90,978	6.74%
Commercial Real Estate:						
Construction	199,524	15.32	304,230	21.53	371,301	27.50
Farmland	85,523	6.56	83,898	5.94	77,504	5.74
Other	441,844	33.92	451,945	31.99	377,130	27.94
Residential Real Estate:						
Multi-family	74,919	5.75	65,043	4.60	56,350	4.17
1-4 Family	353,418	27.13	354,358	25.08	319,734	23.68
Consumer	31,913	2.45	36,989	2.62	37,783	2.80
Agriculture	24,177	1.86	25,064	1.77	16,181	1.20
Other	1,060	0.08	1,488	0.11	3,145	0.23
Total loans	<u>\$ 1,302,668</u>	<u>100.00%</u>	<u>\$ 1,412,918</u>	<u>100.00%</u>	<u>\$ 1,350,106</u>	<u>100.00%</u>

Our lending activities are subject to a variety of lending limits imposed by state and federal law. PBI Bank's secured legal lending limit to a single borrower was approximately \$20.7 million at December 31, 2012.

At December 31, 2012, we had eight loan relationships each with aggregate extensions of credit in excess of \$10 million. Five of the eight relationships include loans that have been classified as substandard by the Bank's internal loan review process. In 2011, we had thirteen loan relationships each with aggregate extensions of credit in excess of \$10 million. For further discussion of classified loans refer to the asset quality discussion in our "Allowance for Loan Losses" section.

Our real estate construction portfolio declined approximately \$31.2 million from 2011 to 2012 as the result of construction projects being completed and sold to end users or refinanced under permanent financing arrangements, and also loans in this category being transferred to OREO through the normal progression of collection, workout, and ultimate disposition. We continue to actively work to reduce the size of our real estate construction portfolio.

As of December 31, 2012, we had \$9.4 million of participations in real estate loans purchased from, and \$61.9 million of participations in real estate loans sold to, other banks. As of December 31, 2011, we had \$16.4 million of participations in real estate loans purchased from, and \$82.7 million of participations in real estate loans sold to, other banks.

Our loan participation totals include participations in real estate loans purchased from and sold to two affiliate banks, The Peoples Bank, Mt. Washington and The Peoples Bank, Taylorsville. Our chairman emeritus, J. Chester Porter and his brother and our director, William G. Porter, each own a 50% interest in Lake Valley Bancorp, Inc., the parent holding company of The Peoples Bank, Taylorsville, Kentucky. J. Chester Porter, William G. Porter and our chairman and chief executive officer, Maria L. Bouvette, serve as directors of The Peoples Bank, Taylorsville. Our chairman emeritus owns an interest of approximately 36.0% and his brother and our director owns an interest of approximately 3.0% in Crossroads Bancorp, Inc., the parent holding company of The Peoples Bank, Mount Washington, Kentucky. J. Chester Porter and Maria L. Bouvette, serve as directors of The Peoples Bank, Mount Washington. During 2012, 2011, and 2010, we entered into management services agreements with each of these banks. Each agreement provides that our executives and employees provide management and accounting services to the subject bank, including overall responsibility for establishing and implementing policy and strategic planning. These entities are not consolidated in the financial statements of the Company. Maria Bouvette also serves as chief financial officer of each of the banks. We received a \$4,000 monthly fee from The Peoples Bank, Taylorsville and a \$2,000 monthly fee from The Peoples Bank, Mount Washington for these services. Beginning in 2013, these management services agreements were not renewed.



As of December 31, 2012, we had \$2.7 million of participations in real estate loans purchased from, and \$6.5 million of participations in real estate loans sold, to these affiliate banks. As of December 31, 2011, we had \$4.1 million of participations in real estate loans purchased from, and \$13.2 million of participations in real estate loans sold to, these affiliate banks. At December 31, 2012, \$1.4 million and \$943,000 of loan participations sold to Peoples Bank, Taylorsville, and Peoples Bank, Mt. Washington, respectively, were on non-accrual.

We have analyzed our relationship with these affiliates and determined that we do not have the power to direct the activities of the affiliates in a manner that would significantly impact their economic performance nor do we govern their absorption of losses or the use of their economic resources. As such, these entities are not consolidated in our financial statements.

**Loan Maturity Schedule** – The following table sets forth information at December 31, 2012, regarding the dollar amount of loans, net of deferred loan fees, maturing in the loan portfolio based on their contractual terms to maturity:

	As of December 31, 2012			
	Maturing Within One Year	Maturing 1 through 5 Years	Maturing Over 5 Years	Total Loans
	(dollars in thousands)			
<b>Loans with fixed rates:</b>				
Commercial	\$ 11,176	\$ 13,616	\$ 2,201	\$ 26,993
Commercial Real Estate:				
Construction	13,383	10,684	1,289	25,356
Farmland	11,654	22,442	6,089	40,185
Other	99,897	114,421	8,808	223,126
Residential Real Estate:				
Multi-family	9,923	31,596	2,857	44,376
1-4 Family	53,511	98,419	67,452	219,382
Consumer	4,442	12,879	1,826	19,147
Agriculture	3,014	1,420	129	4,563
Other	219	—	—	219
Total fixed rate loans	<u>\$ 207,219</u>	<u>\$ 305,477</u>	<u>\$ 90,651</u>	<u>\$ 603,347</u>
<b>Loans with floating rates:</b>				
Commercial	\$ 14,725	\$ 6,330	\$ 4,519	\$ 25,574
Commercial Real Estate:				
Construction	22,222	13,748	8,958	44,928
Farmland	8,685	4,685	27,270	40,640
Other	26,714	35,326	37,521	99,561
Residential Real Estate:				
Multi-family	579	1,290	4,741	6,610
1-4 Family	10,716	14,192	33,983	58,891
Consumer	613	401	222	1,236
Agriculture	11,774	5,332	648	17,754
Other	—	524	27	551
Total floating rate loans	<u>\$ 96,028</u>	<u>\$ 81,828</u>	<u>\$ 117,889</u>	<u>\$ 295,745</u>

**Non-Performing Assets** – Non-performing assets consist of certain restructured loans for which interest rate or other terms have been renegotiated, loans past due 90 days or more still on accrual, loans on which interest is no longer accrued, real estate acquired through foreclosure and repossessed assets. Loans, including impaired loans, are placed on non-accrual status when they become past due 90 days or more as to principal or interest, unless they are adequately secured and in the process of collection. Loans are considered impaired if full principal or interest payments are not anticipated in accordance with the contractual loan terms. Impaired loans are carried at the present value of expected future cash flows discounted at the loan's effective interest rate or at the fair value of the collateral less cost to sell if the loan is collateral dependent. Loans are reviewed on a regular basis and normal collection procedures are implemented when a borrower fails to make a required payment on a loan. If the delinquency on a mortgage loan exceeds 90 days and is not cured through normal collection procedures or an acceptable arrangement is not worked out with the borrower, we institute measures to remedy the default, including commencing a foreclosure action. Consumer loans generally are charged off when a loan is deemed uncollectible by management and any available collateral has been disposed. Commercial business and real estate loan delinquencies are handled on an individual basis by management with the advice of legal counsel.

Interest income on loans is recognized on the accrual basis except for those loans placed on non-accrual status. The accrual of interest on impaired loans is discontinued when management believes, after consideration of economic and business conditions and collection efforts, that the borrowers' financial condition is such that collection of interest is doubtful, which typically occurs after the loan becomes 90 days delinquent. When interest accrual is discontinued, existing accrued interest is reversed and interest income is subsequently recognized only to the extent cash payments are received on well-secured loans.

Real estate acquired as a result of foreclosure or by deed in lieu of foreclosure is classified as real estate owned until such time as it is sold. New and used automobiles and other motor vehicles acquired as a result of foreclosure are classified as repossessed assets until they are sold. When such property is acquired it is recorded at its fair market value less cost to sell. Any write-down of the property at the time of acquisition is charged to the allowance for loan losses. Subsequent gains and losses are included in non-interest expense.

The following table sets forth information with respect to non-performing assets as of the dates indicated:

	<b>As of December 31,</b>				
	<b>2012</b>	<b>2011</b>	<b>2010</b>	<b>2009</b>	<b>2008</b>
	(dollars in thousands)				
Past due 90 days or more still on accrual	\$ 86	\$ 1,350	\$ 594	\$ 5,968	\$ 11,598
Loans on non-accrual status	94,517	92,020	59,799	78,888	9,725
Total non-performing loans	94,603	93,370	60,393	84,856	21,323
Real estate acquired through foreclosure	43,671	41,449	67,635	14,548	7,839
Other repossessed assets	—	5	52	80	96
Total non-performing assets	<u>\$ 138,274</u>	<u>\$ 134,824</u>	<u>\$ 128,080</u>	<u>\$ 99,484</u>	<u>\$ 29,258</u>
Non-performing loans to total loans	10.52%	8.22%	4.63%	6.00%	1.58%
Non-performing assets to total assets	11.89%	9.26%	7.43%	5.42%	1.78%
Allowance for non-performing loans	\$ 13,250	\$ 11,382	\$ 7,977	\$ 7,266	\$ 2,363
Allowance for non-performing loans to non-performing loans	14.0%	12.2%	13.2%	8.6%	11.1%

A troubled debt restructuring (TDR) is where the Company has agreed to a loan modification in the form of a concession for a borrower who is experiencing financial difficulty. The majority of the Company's TDRs involve a reduction in interest rate, a deferral of principal for a stated period of time, or an interest only period. All TDRs are considered impaired, and the Company has allocated reserves for these loans to reflect the present value of the concessionary terms granted to the customer. If the loan is considered collateral dependent, it is reported net of allocated reserves, at the fair value of the collateral less cost to sell.

We do not have a formal loan modification program. Rather, we work with individual borrower on a case-by-case basis to facilitate the orderly collection of our principal and interest before a loan becomes a non-performing loan. If a borrower is unable to make contractual payments, we review the particular circumstances of that borrower's situation and negotiate a revised payment stream. In other words, we identify performing borrowers experiencing financial difficulties, and through negotiations, we lower their interest rate, most typically on a short-term basis for three to six months. Our goal when restructuring a credit is to afford the borrower a reasonable period of time to remedy the issue causing cash flow constraints within their business so that they can return to performing status over time.

Our loan modifications have taken the form of reduction in interest rate and/or curtailment of scheduled principal payments for a short-term period, usually three to six months, but in some cases until maturity of the loan. In some circumstances we restructure real estate secured loans in a bifurcated fashion whereby we have a fully amortizing "A" loan at a market interest rate and an interest-only "B" loan at a reduced interest rate. Our restructured loans are all collateral secured loans. If a customer fails to perform under the modified terms, we place the loan(s) on non-accrual status and begin the process of working with the customer to liquidate the underlying collateral to satisfy the debt.

At December 31, 2012, we had 123 restructured loans totaling \$117.8 million with borrowers who experienced deterioration in financial condition compared with 114 loans totaling \$113.7 million at December 31, 2011. In general, these loans were granted interest rate reductions to provide cash flow relief to borrowers experiencing cash flow difficulties. Of these restructured loans for 2012, five loans totaling approximately \$5.2 million were also granted principal payment deferrals until maturity. There were no concessions made to forgive principal relative to these loans, although we have recorded partial charge-offs for certain restructured loans. In general, these loans are secured by first liens on 1-4 residential or commercial real estate properties, or farmland. Restructured loans also included \$3.8 million of commercial loans for 2012. At December 31, 2012, \$77.3 million of TDRs were performing according to their modified terms.

In accordance with current guidance, we continue to report restructured loans as restructured until such time as the loan is paid in full, otherwise settled, sold, or charged-off. If the borrower fails to perform, we place the loan on non-accrual status and seek to liquidate the underlying collateral for these loans. Our non-accrual policy for restructured loans is identical to our non-accrual policy for all loans. Our policy calls for a loan to be reported as non-accrual if it is maintained on a cash basis because of deterioration in the financial condition of the borrower, payment in full of principal and interest is not expected, or principal or interest has been in default for a period of 90 days or more unless the assets are both well secured and in the process of collection. Changes in value for impairment, including the amount attributed to the passage of time, are recorded entirely within the provision for loan losses.

We consider any loan that is restructured for a borrower experiencing financial difficulties due to a borrower's potential inability to pay in accordance with contractual terms of the loan to be a troubled debt restructure. Specifically, we consider a concession involving a modification of the loan terms, such as (i) a reduction of the stated interest rate, (ii) reduction or deferral of principal, or (iii) reduction or deferral of accrued interest at a stated interest rate lower than the current market rate for new debt with similar risk all to be troubled debt restructurings. When a modification of terms is made for a competitive reason, we do not consider that to be a troubled debt restructuring. A primary example of a competitive modification would be an interest rate reduction for a performing customer's loan to a market rate as the result of a market decline in rates.

See Footnote 4, "Loans", to the financial statements for additional disclosure related to troubled debt restructuring.

Interest income that would have been earned on non-performing loans was \$4.9 million, \$4.0 million, and \$2.7 million for the years ended December 31, 2012, 2011, and 2010, respectively. Interest income recognized on accruing non-performing loans was \$460,000, \$611,000, and \$222,000 for the years ended December 31, 2012, 2011, and 2010, respectively.

Loans more than 90 days past due decreased \$1.3 million, and non-accrual loans increased \$2.5 million, respectively, from December 31, 2011 to December 31, 2012. The \$94.6 million in nonperforming loans at December 31, 2012, and \$93.4 million at December 31, 2011, were primarily construction, land development, other land, commercial real estate, and residential real estate loans. The protracted slowdown in housing unit sales and loss of tenants or inability to lease vacant office and retail space has placed inordinate stress on these customers and their ability to repay according to the contractual terms of the loans. As such, we have placed these credits on non-accrual and have begun the appropriate collection actions to resolve them. Management believes it has established adequate loan loss reserves for these credits.

Loans past due 30-59 days increased from \$17.3 million at December 31, 2011 to \$38.2 million at December 31, 2012. Loans past due 60-89 days increased from \$3.9 million at December 31, 2011 to \$20.3 million at December 31, 2012. This represents a \$37.2 million increase from December 31, 2011 to December 31, 2012, in loans past due 30-89 days. These increases were primarily in the construction and residential real estate segments of the portfolio. We considered this trend in delinquency levels during the evaluation of qualitative trends in the portfolio when establishing the general component of our allowance for loan losses. Subsequent to December 31, 2012, loans to two significant borrowing relationships, which at December 31, 2012 were past due 30-59 days totaling \$23.5 million and past due 60-89 days totaling \$12.7 million, were placed on non-accrual. These loans were classified as impaired and allocated reserves of \$4.9 million at December 31, 2012.

**Foreclosed Properties** – Foreclosed properties at December 31, 2012 were \$43.7 million compared with \$41.4 million at December 31, 2011. See Footnote 6, "Other Real Estate Owned", to the financial statements. During 2012, we acquired \$33.5 million of OREO properties and sold properties totaling approximately \$24.2 million. We value foreclosed properties at fair value less estimated costs to sell when acquired and expect to liquidate these properties to recover our investment in the due course of business.

Other real estate owned (OREO) is recorded at fair market value less estimated cost to sell at time of acquisition. Any write-down of the property at the time of acquisition is charged to the allowance for loan losses. Subsequent reductions in fair value are recorded as non-interest expense. To determine the fair value of OREO for smaller dollar, single family homes, we consult with internal real estate sales staff and external realtors, investors, and appraisers. If the internally evaluated market price is below our underlying investment in the property, we record an appropriate write-down.

For larger dollar commercial real estate properties, we obtain a new appraisal of the subject property in connection with the transfer to OREO. In some of these circumstances, an appraisal is in process at quarter end and we must make our best estimate of the fair value of the underlying collateral based on our internal evaluation of the property, our review of the most recent appraisal, and discussions with the currently engaged appraiser. We obtain updated appraisals on the anniversary date of ownership unless a sale is imminent.

The following table presents the major categories of OREO at the year-ends indicated:

	<u>2012</u>	<u>2011</u>
	(in thousands)	
Commercial Real Estate:		
Construction	\$ 22,323	\$ 31,280
Farmland	602	715
Other	15,175	6,364
Residential Real Estate:		
Multi-family	195	—
1-4 Family	5,376	3,090
	<u>\$ 43,671</u>	<u>\$ 41,449</u>

Net activity relating to other real estate owned during the years indicated is as follows:

	<u>2012</u>	<u>2011</u>
	(in thousands)	
<b>OREO Activity</b>		
OREO as of January 1	\$ 41,449	\$ 67,635
Real estate acquired	33,528	41,917
Valuation adjustments for sales strategy change	—	(25,613)
Valuation adjustments for declining market values	(7,154)	(9,261)
Improvements	1	1,650
Loss on sale	(1,672)	(8,889)
Proceeds from sale of properties	(22,481)	(25,990)
OREO as of December 31	<u>\$ 43,671</u>	<u>\$ 41,449</u>

Net loss on sales, write-downs, and operating expenses for OREO totaled \$10.5 million for the year ended December 31, 2012, compared with \$47.5 million for the same period of 2011. The 2011 results were impacted significantly by our determination in the 2011 second quarter that certain properties held in other real estate were not likely to be successfully disposed of in an acceptable time-frame using routine marketing efforts. It became apparent that certain condominium projects were going to require extended holding periods to sell the properties at their most recent appraised values. Accordingly, during June 2011, the Company sold, in a single transaction, 54 finished condominium property units from several condominium developments in our OREO portfolio, with a carrying value of approximately \$11.0 million for \$5.2 million, resulting in a pre-tax loss of \$5.8 million. In addition, management adjusted its valuations for similar condominium and residential development properties held in other real estate through provision of an allowance of \$10.6 million on other real estate held, with the objective of marketing these properties more aggressively.

Although we were carrying our OREO at fair market value less estimated cost to sell, we subsequently adjusted our valuations for land development and residential development properties held in OREO similar to the properties we sold in 2011. We recorded an allowance totaling approximately \$25.6 million during 2011 to reflect our intent to market these properties more aggressively to retail and bulk buyers. No similar change in sales strategy was implemented during 2012.

We recorded approximately \$7.7 million and \$8.3 million of fair value write-downs related to new appraisals received for properties in the OREO portfolio during 2012 and 2011 respectively. We were successful in selling OREO totaling \$24.2 million and \$34.9 million during 2012 and 2011, respectively.

**Allowance for Loan Losses** – The allowance for loan losses is based on management’s continuing review and evaluation of individual loans, loss experience, current economic conditions, risk characteristics of various categories of loans and such other factors that, in management’s judgment, require current recognition in estimating loan losses.

The following table sets forth an analysis of loan loss experience as of and for the periods indicated:

	<b>As of December 31,</b>				
	<b>2012</b>	<b>2011</b>	<b>2010</b>	<b>2009</b>	<b>2008</b>
	<b>(dollars in thousands)</b>				
Balances at beginning of period	\$ 52,579	\$ 34,285	\$ 26,392	\$ 19,652	\$ 16,342
Loans charged-off:					
Real estate	31,437	38,538	19,261	6,519	2,711
Commercial	3,784	4,197	2,675	301	347
Consumer	1,130	1,070	496	875	749
Agriculture	1,164	841	29	36	27
Total charge-offs	<u>37,515</u>	<u>44,646</u>	<u>22,461</u>	<u>7,731</u>	<u>3,834</u>
Recoveries:					
Real estate	1,040	184	114	133	145
Commercial	129	69	28	55	85
Consumer	125	87	104	76	85
Agriculture	72	—	8	7	8
Total recoveries	<u>1,366</u>	<u>340</u>	<u>254</u>	<u>271</u>	<u>323</u>
Net charge-offs	<u>36,149</u>	<u>44,306</u>	<u>22,207</u>	<u>7,460</u>	<u>3,511</u>
Provision for loan losses	40,250	62,600	30,100	14,200	5,400
Balance acquired in bank acquisition	—	—	—	—	1,421
Balance at end of period	<u>\$ 56,680</u>	<u>\$ 52,579</u>	<u>\$ 34,285</u>	<u>\$ 26,392</u>	<u>\$ 19,652</u>
Allowance for loan losses to period-end loans	6.30%	4.63%	2.63%	1.87%	1.46%
Net charge-offs to average loans	3.50%	3.56%	1.64%	0.54%	0.27%
Allowance for loan losses to non-performing loans	59.91%	56.31%	56.77%	31.10%	92.16%

Our allowance for loan losses is a reserve established through charges to earnings in the form of a provision for loan losses. The allowance for loan losses is comprised of specific reserves and general reserves. Generally, all loans that have been identified as impaired are reviewed on a quarterly basis in order to determine whether a specific allowance is required. A loan is considered impaired when based on current information, it is probable that we will not receive all amounts due in accordance with the contractual terms of the loan agreement. Once a loan has been identified as impaired, management measures impairment in accordance with ASC 310.10, "Impairment of a Loan." When management's measured value 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 our loss exposure for each credit given the payment status, financial condition of the borrower and value of any underlying collateral. Loans for which specific reserves have been provided are excluded from the general reserve calculations described below. Changes in specific reserves from period to period are the result of changes in the circumstances of individual loans such as charge-offs, pay-offs, changes in collateral values or other factors.

The allowance for loan losses represents management's estimate of the amount necessary to provide for known and inherent losses in the loan portfolio in the normal course of business. Due to the uncertainty of risks in the loan portfolio, management's judgment of the amount of the allowance necessary to absorb loan losses is approximate. The allowance for loan losses is also subject to regulatory examinations and may be adjusted in response to a determination by the regulatory agencies as to its adequacy in comparison with peer institutions.

We make specific allowances for each impaired loan based on its type and classification as discussed above. At year-end 2012, our allowance for loan losses to total non-performing loans increased to 59.9% from 56.3% at year-end 2011. We have assessed these loans for collectability and considered, among other things, the borrower's ability to repay, the value of the underlying collateral, and other market conditions to ensure that the allowance for loan losses is adequate to absorb probable incurred losses. We also maintain a general reserve for each loan type in the loan portfolio. In determining the amount of the general reserve portion of our allowance for loan losses, management considers factors such as our historical loan loss experience, the growth, composition and diversification of our loan portfolio, current delinquency levels, the results of recent regulatory examinations and general economic conditions. Based on these factors, we apply estimated percentages to the various categories of loans, not including any loan that has a specific allowance allocated to it, based on our historical experience, portfolio trends and economic and industry trends. This information is used by management to set the general reserve portion of the allowance for loan losses at a level it deems prudent.

Our portfolio is comprised primarily of loans secured by real estate. A decline in the value of the real estate serving as collateral for our loans may impact our ability to collect those loans. In general, we obtain updated appraisals on property securing our loans when circumstances are warranted such as at the time of renewal or when market conditions have significantly changed. We use qualified licensed appraisers approved by our Board of Directors. These appraisers possess prerequisite certifications and knowledge of the local and regional marketplace.

Based on an evaluation of the loan portfolio, management presents a quarterly review of the allowance for loan losses to our Board of Directors, indicating any change in the allowance for loan losses since the last review and any recommendations as to adjustments in the allowance for loan losses.

This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available or as events change. We increased the allowance for loan losses as a percentage of loans outstanding to 6.30% at December 31, 2012 from 4.63% at December 31, 2011. The level of the allowance is based on estimates and the ultimate losses may vary from these estimates.

We follow a loan grading program designed to evaluate the credit risk in our loan portfolio. Through this loan grading process, we maintain an internally classified watch list which helps management assess the overall quality of the loan portfolio and the adequacy of the allowance for loan losses. Loans categorized as watch list loans show warning elements where the present status exhibits one or more deficiencies that require attention in the short-term or where pertinent ratios of the loan account have weakened to a point where more frequent monitoring is warranted. These loans do not have all of the characteristics of a classified loan (substandard or doubtful) but do show weakened elements as compared with those of a satisfactory credit. We review these loans to assist in assessing the adequacy of the allowance for loan losses.

In establishing the appropriate classification for specific assets, management considers, among other factors, the estimated value of the underlying collateral, the borrower's ability to repay, the borrower's repayment history and the current delinquent status. As a result of this process, loans are categorized as special mention, substandard or doubtful.

Loans classified as "special mention" do not have all of the characteristics of substandard or doubtful loans. They have one or more deficiencies which warrant special attention and which corrective action, such as accelerated collection practices, may remedy.

Loans classified as "substandard" are those loans with clear and defined weaknesses such as a highly leveraged position, unfavorable financial ratios, uncertain repayment sources or poor financial condition which may jeopardize the repayment of the debt as contractually agreed. They are characterized by the distinct possibility that we will sustain some losses if the deficiencies are not corrected.

Loans classified as "doubtful" are those loans which have characteristics similar to substandard loans but with an increased risk that collection or liquidation in full is highly questionable and improbable.

Once a loan is deemed impaired or uncollectible as contractually agreed, the loan is charged-off either partially or in-full against the allowance for loan losses, based upon the expected future cash flows discounted at the loan's effective interest rate, or the fair value of collateral less estimated cost to sell with respect to collateral-based loans.

As of December 31, 2012, we had \$248.7 million of loans classified as substandard, \$396,000 classified as doubtful, \$34.7 million classified as special mention and none classified as loss. This compares with \$229.6 million of loans classified as substandard, \$391,000 classified as doubtful, \$48.9 million classified as special mention and none classified as loss as of December 31, 2011. The \$19.1 million increase in loans classified as substandard was primarily concentrated in the commercial real estate portfolio. As of December 31, 2012, we had allocations of \$34.0 million in the allowance for loan losses related to these classified loans. This compares to allocations of \$30.2 million in the allowance for loan losses related to classified loans at December 31, 2011.

We recorded a provision for loan losses of \$40.3 million for the year ended December 31, 2012, compared with \$62.6 million for 2011 and \$30.1 million for 2010. The total allowance for loan losses was \$56.7 million or 6.30% of total loans, at December 31, 2012, compared with \$52.6 million or 4.63% of total loans at December 31, 2011, and \$34.3 million or 2.63% of total loans at December 31, 2010. The increased allowance is consistent with the increase in our classified loans of \$39.0 million from December 31, 2011 to December 31, 2012, loan charge-off trends, and other trends within the portfolio, in particular the protracted slowdown in housing unit sales and continued weakness in demand for residential land in our markets. Net charge-offs were \$36.1 million for the year ended December 31, 2012, compared with \$44.3 million for 2011 and \$22.2 million for 2010. Charge-offs for 2012 were concentrated in the loans secured by real estate category of the portfolio. Real estate charge-offs represents 84% of our net charge-offs for 2012. These net charge-offs consisted of \$18.3 million of commercial real estate loans, \$8.9 million of residential real estate loans, and \$3.2 million of construction and land development loans. The continued weakness in the real estate sector of the market continued to exert downward pressure on the value of real estate securing our loans. We continue to closely monitor real estate values for property that secures our loans to ensure our allowance is adequate.

The following table depicts management's allocation of the allowance for loan losses by loan type. Allowance funding and allocation is based on management's current evaluation of risk in each category, economic conditions, past loss experience, loan volume, past due history and other factors. Since these factors and management's assumptions are subject to change, the allocation is not necessarily predictive of future portfolio performance. The allocation is made by analytical purposes and is not necessarily indicative of the categories in which future losses may occur. The total allowance is available to absorb losses from any segment of loans.

	As of December 31,			
	2012		2011	
	Amount of Allowance	Percent of Loans to Total Loans	Amount of Allowance	Percent of Loans to Total Loans
	(dollars in thousands)			
Commercial	\$ 4,402	5.85%	\$ 4,207	6.27%
Commercial Real Estate:				
Construction	5,989	7.82	13,920	8.93
Farmland	2,600	8.99	2,023	8.01
Other	26,179	35.89	17,081	37.31
Residential Real Estate:				
Multi-family	2,464	5.67	1,797	5.31
1-4 Family	13,771	30.95	12,420	29.70
Consumer	857	2.27	792	2.29
Agriculture	403	2.48	325	2.09
Other	15	0.08	14	0.09
Total	<u>\$ 56,680</u>	<u>100.00%</u>	<u>\$ 52,579</u>	<u>100.00%</u>

	As of December 31,					
	2010		2009		2008	
	Amount of Allowance	Percent of Loans to Total Loans	Amount of Allowance	Percent of Loans to Total Loans	Amount of Allowance	Percent of Loans to Total Loans
	(dollars in thousands)					
Commercial	\$ 2,147	6.93%	\$ 2,040	6.36%	\$ 1,623	6.74%
Commercial Real Estate:						
Construction	11,164	15.32	8,215	21.53	5,907	27.50
Farmland	702	6.56	643	5.94	882	5.74
Other	12,209	33.92	9,266	31.99	6,770	27.94
Residential Real Estate:						
Multi-family	517	5.75	578	4.60	590	4.17
1-4 Family	6,707	27.13	4,662	25.08	2,271	23.68
Consumer	701	2.45	538	2.62	603	2.80
Agriculture	134	1.86	163	1.77	238	1.20
Other	4	0.08	5	0.11	26	0.23
Unallocated	—	—	282	—	742	—
Total	<u>\$ 34,285</u>	<u>100.00%</u>	<u>\$ 26,392</u>	<u>100.00%</u>	<u>\$ 19,652</u>	<u>100.00%</u>

**Investment Securities** – The securities portfolio serves as a source of liquidity and earnings and contributes to the management of interest rate risk. We have the authority to invest in various types of liquid assets, including short-term United States Treasury obligations and securities of various federal agencies, obligations of states and political subdivisions, corporate bonds, certificates of deposit at insured savings and loans and banks, bankers' acceptances and federal funds. We may also invest a portion of our assets in certain commercial paper and corporate debt securities. We are also authorized to invest in mutual funds and stocks whose assets conform to the investments that we are authorized to make directly. The investment portfolio increased by \$19.6 million, or 12.4%, to \$178.5 million at December 31, 2012, compared with \$158.9 million at December 31, 2011.

The following table sets forth the carrying value of our securities portfolio at the dates indicated. There were no securities classified as held-to-maturity at either period end.

	December 31, 2012				December 31, 2011			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(dollars in thousands)							
Securities available-for-sale								
U.S. Treasury and agencies	\$ 5,603	\$ 530	\$ —	\$ 6,133	\$ 10,494	\$ 1,149	\$ —	\$ 11,643
Agency mortgage-backed: residential	94,298	1,141	(257)	95,182	97,286	2,211	(22)	99,475
State and municipal	52,485	2,335	(87)	54,733	35,456	2,610	(4)	38,062
Corporate	18,851	1,150	(37)	19,964	7,259	315	(242)	7,332
Other debt	572	46	—	618	572	34	—	606
Equity	1,359	487	—	1,846	1,359	356	—	1,715
Total	<u>\$ 173,168</u>	<u>\$ 5,689</u>	<u>\$ (381)</u>	<u>\$178,476</u>	<u>\$ 152,426</u>	<u>\$ 6,675</u>	<u>\$ (268)</u>	<u>\$158,833</u>

The following table sets forth the contractual maturities, fair values and weighted-average yields for our securities held at December 31, 2012:

	Due Within One Year		After One Year But Within Five Years		After Five Years But Within Ten Years		After Ten Years		Total	
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield
	U.S. Treasury and agencies	\$ —	—%	\$ 3,525	2.59%	\$ 2,608	3.39%	\$ —	—%	\$ 6,133
Agency mortgage-backed	—	—	828	4.76	802	5.17	93,552	1.60	95,182	1.65
State and municipal	930	6.51	3,004	5.62	22,729	3.90	28,070	3.75	54,733	3.96
Corporate bonds	—	—	7,235	6.21	1,123	5.14	11,606	2.33	19,964	3.77
Other debt	—	—	—	—	—	—	618	6.50	618	6.50
Total	<u>\$ 930</u>	<u>6.51%</u>	<u>\$ 14,592</u>	<u>5.08%</u>	<u>\$ 27,262</u>	<u>3.94%</u>	<u>\$133,846</u>	<u>2.12%</u>	<u>\$176,630</u>	<u>2.65%</u>
Equity									1,846	
Total									<u>\$178,476</u>	

Average yields in the table above were calculated on a tax equivalent basis using a federal income tax rate of 35%. Mortgage-backed securities are securities that have been developed by pooling a number of real estate mortgages. These securities are issued by federal agencies such as Government National Mortgage Association (“Ginnie Mae”), Fannie Mae and Freddie Mac, as well as non-agency company issuers. These securities are deemed to have high credit ratings, and minimum regular monthly cash flows of principal and interest. Cash flows from agency backed mortgage-backed securities are guaranteed by the issuing agencies.

Unlike U.S. Treasury and U.S. government agency securities, which have a lump sum payment at maturity, mortgage-backed securities provide cash flows from regular principal and interest payments and principal prepayments throughout the lives of the securities. Mortgage-backed securities that are purchased at a premium will generally suffer decreasing net yields as interest rates drop because home owners tend to refinance their mortgages. Thus, the premium paid must be amortized over a shorter period. Therefore, those securities purchased at a discount will obtain higher net yields in a decreasing interest rate environment. As interest rates rise, the opposite will generally be true. During a period of increasing interest rates, fixed rate mortgage-backed securities do not tend to experience heavy prepayments of principal and consequently, the average life of this security will not be shortened. If interest rates begin to fall, prepayments will increase. Non-agency issuer mortgage-backed securities do not carry a government guarantee. We limit our purchases of these securities to bank qualified issues with high credit ratings. We regularly monitor the performance and credit ratings of these securities and evaluate these securities, as we do all of our securities, for other-than-temporary impairment on a quarterly basis. At December 31, 2012, 98.4% of the agency mortgage-backed securities we held had contractual final maturities of more than ten years with a weighted average life of 24.9 years.

In December 2011, based upon relevant market information, we determined that our basis in twelve equity securities with an unrealized loss position for more the 12 months was not recoverable in the near term. Therefore, during 2011, we recorded an other-than-temporary impairment charge totaling \$41,000 for these securities which had an adjusted cost basis of \$206,000.

The Company held 40 equity securities at December 31, 2012. Management monitors the underlying financial condition of the issuers and current market pricing for these equity securities monthly. At December 31, 2012, we had one equity securities in our portfolio with an unrealized loss of less than \$500.

**Deposits** – We attract both short-term and long-term deposits from the general public by offering a wide range of deposit accounts and interest rates. In recent years, we have been required by market conditions to rely increasingly on short to mid-term certificate accounts and other



deposit alternatives, including brokered and wholesale deposits, which are more responsive to market interest rates. We use forecasts based on interest rate risk simulations to assist management in monitoring our use of certificates of deposit and other deposit products as funding sources and the impact of their use on interest income and net interest margin in various rate environments. At December 31, 2012, brokered deposits totaled \$15.0 million. We are currently restricted from accepting, renewing, or rolling-over brokered deposits without the prior receipt of a waiver on a case-by-case basis from our regulators.

We primarily rely on our banking office network to attract and retain deposits in our local markets and leverage our online Ascencia division to attract out-of-market deposits. Market interest rates and rates on deposit products offered by competing financial institutions can significantly affect our ability to attract and retain deposits. During 2012, total deposits decreased \$258.7 million compared with 2011. During 2011, total deposits decreased \$143.9 million compared with 2010. The decrease in deposits for 2012 and 2011 was primarily in certificates of deposit balances and money market accounts.

To evaluate our funding needs in light of deposit trends resulting from continually changing conditions, management and board committees evaluate simulated performance reports that forecast changes in margins along with other pertinent economic data. We continue to offer attractively priced deposit products along our product line to allow us to retain deposit customers and reduce interest rate risk during various rising and falling interest rate cycles.

We offer savings accounts, NOW accounts, money market accounts and fixed rate certificates with varying maturities. The flow of deposits is influenced significantly by general economic conditions, changes in interest rates and competition. Our management adjusts interest rates, maturity terms, service fees and withdrawal penalties on our deposit products periodically. The variety of deposit products allows us to compete more effectively in obtaining funds and to respond with more flexibility to the flow of funds away from depository institutions into outside investment alternatives. However, our ability to attract and maintain deposits and the costs of these funds has been, and will continue to be, significantly affected by market conditions.

The following table sets forth the average daily balances and weighted average rates paid for our deposits for the periods indicated:

	For the Years Ended December 31,					
	2012		2011		2010	
	Average Balance	Average Rate	Average Balance	Average Rate	Average Balance	Average Rate
	(dollars in thousands)					
Demand	\$ 113,325		\$ 106,769		\$ 102,383	
Interest Checking	89,820	0.37%	89,103	0.74%	83,111	0.85%
Money Market	63,212	0.49	81,925	0.96	81,430	1.24
Savings	38,665	0.40	36,511	0.62	35,393	0.74
Certificates of Deposit	912,061	1.52	1,120,154	1.65	1,156,724	2.02
Total Deposits	<u>\$ 1,217,083</u>		<u>\$ 1,434,462</u>		<u>\$ 1,459,041</u>	
Weighted Average Rate		1.20%		1.40%		1.74%

The following table sets forth the average daily balances and weighted average rates paid for our certificates of deposit for the periods indicated:

	For the Years Ended December 31,					
	2012		2011		2010	
	Average Balance	Average Rate	Average Balance	Average Rate	Average Balance	Average Rate
	(dollars in thousands)					
Certificates of Deposit						
Less than \$100,000	\$ 478,502	1.40%	\$ 569,667	1.59%	\$ 579,978	2.00%
\$100,000 or more	433,559	1.64	550,487	1.71	576,746	2.05
Total	<u>\$ 912,061</u>	1.52%	<u>\$ 1,120,154</u>	1.65%	<u>\$ 1,156,724</u>	2.02%

The following table shows at December 31, 2012 the amount of our time deposits of \$100,000 or more by time remaining until maturity:

Maturity Period	Retail	Brokered	Total
	(in thousands)		
Three months or less	\$ 40,770	\$ —	\$ 40,770
Three months through six months	38,900	15,000	53,900
Six months through twelve months	64,762	—	64,762
Over twelve months	160,095	—	160,095
Total	<u>\$ 304,527</u>	<u>\$ 15,000</u>	<u>\$ 319,527</u>

We strive to maintain competitive pricing on our deposit products which we believe allows us to retain a substantial percentage of our customers when their time deposits mature.

**Borrowing** – Deposits are the primary source of funds for our lending and investment activities and for our general business purposes. We can also use advances (borrowings) from the FHLB of Cincinnati to supplement our pool of lendable funds, meet deposit withdrawal requirements and manage the terms of our liabilities. Advances from the FHLB are secured by our stock in the FHLB, certain commercial real estate loans and substantially all of our first mortgage residential loans. At December 31, 2012, we had \$5.6 million in advances outstanding from the FHLB and the capacity to increase our borrowings an additional \$23.0 million. The FHLB of Cincinnati functions as a central reserve bank providing credit for savings banks and other member financial institutions. As a member, we are required to own capital stock in the FHLB and are authorized to apply for advances on the security of such stock and certain of our home mortgages and other assets (principally, securities which are obligations of, or guaranteed by, the United States) provided that we meet certain standards related to creditworthiness.

The following table sets forth information about our FHLB advances as of and for the periods indicated:

	December 31,		
	2012	2011	2010
	(dollars in thousands)		
Average balance outstanding	\$ 6,325	\$ 15,315	\$ 47,800
Maximum amount outstanding at any month-end during the period	7,015	38,937	110,763
End of period balance	5,604	7,116	15,022
Weighted average interest rate:			
At end of period	3.21%	3.31%	3.87%
During the period	3.27%	3.51%	4.22%

**Subordinated Capital Note** – At December 31, 2012, our bank subsidiary, PBI Bank, had a subordinated capital note outstanding in the amount of \$7.0 million. The note is unsecured, bears interest at the BBA three-month LIBOR floating rate plus 300 basis points, and qualifies as Tier 2 capital. Interest only was due quarterly through September 30, 2010, at which time quarterly principal payments of \$225,000 plus interest commenced. The note is due July 1, 2020. At December 31, 2012, the interest rate on this note was 3.36%.

**Junior Subordinated Debentures** – At December 31, 2012, we had four issues of junior subordinated debentures outstanding totaling \$25.0 million as shown in the table below.

Description	Liquidation Amount Trust Preferred Securities (dollars in thousands)	Issuance Date	Optional Prepayment Date (2)	Interest Rate (1)	Junior Subordinated Debt and Investment in Trust (dollars in thousands)	Maturity Date
Porter Statutory Trust II	\$ 5,000	2/13/2004	3/17/2009	3-month LIBOR + 2.85%	\$ 5,155	2/13/2034
Porter Statutory Trust III	3,000	4/15/2004	6/17/2009	3-month LIBOR + 2.79%	3,093	4/15/2034
Porter Statutory Trust IV	14,000	12/14/2006	3/1/2012	3-month LIBOR + 1.67%	14,434	3/1/2037
Asencia Statutory Trust I	3,000	2/13/2004	3/17/2009	3-month LIBOR + 2.85%	3,093	2/13/2034
	<u>\$ 25,000</u>				<u>\$ 25,775</u>	

(1) As of December 31, 2012, the 3-month LIBOR was 0.31%.

(2) The debentures are callable on or after the optional prepayment date at their principal amount plus accrued interest.

The trust preferred securities are subject to mandatory redemption, in whole or in part, upon repayment of the subordinated debentures at maturity or their earlier redemption at the liquidation preference. The subordinated debentures, which mature February 13, 2034, April 15, 2034, and March 1, 2037, are redeemable before the maturity date at our option on or after March 17, 2009, June 17, 2009, and March 1, 2012, respectively, at their principal amount plus accrued interest. We have the option to defer interest payments on the subordinated debentures from time to time for a period not to exceed 20 consecutive quarters. After such period, we must pay all deferred interest and resume quarterly interest payments or we will be in default. Effective with the fourth quarter of 2011, we began deferring interest payments on our junior subordinated debentures.

Deferring interest payments on our junior subordinated notes resulted in the deferral of distributions on our trust preferred securities. We will be prohibited from paying cash dividends on our common stock until such time as we have paid all deferred distributions on our trust preferred securities.

The trust preferred securities issued by our subsidiary trusts are currently included in our Tier 1 capital for regulatory purposes. On March 1, 2005, the Federal Reserve Board adopted final rules that continue to allow trust preferred securities to be included in Tier 1 capital, subject to stricter quantitative and qualitative limits. Currently, no more than 25% of our Tier 1 capital can consist of trust preferred securities and qualifying perpetual preferred stock. To the extent the amount of our trust preferred securities exceeds the 25% limit, the excess would be includable in Tier 2 capital. The new quantitative limits were effective March 31, 2011. As of December 31, 2012, Porter Bancorp's trust preferred securities totaled 25% of its Tier 1 capital and 37% of its Tier 2 capital.

Each of the trusts issuing the trust preferred securities holds junior subordinated debentures we issued with a 30 year maturity. The final rules provide that in the last five years before the junior subordinated debentures mature, the associated trust preferred securities will be excluded from Tier 1 capital and included in Tier 2 capital. In addition, the trust preferred securities during this five-year period would be amortized out of Tier 2 capital by one-fifth each year and excluded from Tier 2 capital completely during the year before maturity.

## Liquidity

Liquidity risk arises from the possibility we may not be able to satisfy current or future financial commitments, or may become unduly reliant on alternative funding sources. The objective of liquidity risk management is to ensure that we meet the cash flow requirements of depositors and borrowers, as well as our operating cash needs, taking into account all on- and off-balance sheet funding demands. Liquidity risk management also involves ensuring that we meet our cash flow needs at a reasonable cost. We maintain an investment and funds management policy, which identifies the primary sources of liquidity, establishes procedures for monitoring and measuring liquidity, and establishes minimum liquidity requirements in compliance with regulatory guidance. Our Asset Liability Committee continually monitors and reviews our liquidity position.

Funds are available from a number of sources, including the sale of securities in the available-for-sale portion of the investment portfolio, principal pay-downs on loans and mortgage-backed securities, customer deposit inflows, brokered deposits and other wholesale funding. During 2012 and 2011, we utilized brokered deposits to supplement our funding strategy. At December 31, 2012, these deposits totaled \$15.0 million compared with \$118.4 million at December 31, 2011. We are currently restricted from accepting, renewing, or rolling-over brokered deposits without the prior receipt of a waiver on a case-by-case basis from our regulators. The following table shows at December 31, 2012, the amount of our brokered certificates of deposit by time remaining to maturity (in thousands):

Three months or less	\$	—
Three months through six months		15,000
Six months through twelve months		—
Over twelve months		—
Total	<u>\$</u>	<u>15,000</u>

Traditionally, we have borrowed from the FHLB to supplement our funding requirements. At December 31, 2012, we had an unused borrowing capacity with the FHLB of \$23.0 million.

After December 31, 2011, as a result of our recent financial results, the FHLB changed our collateral arrangements from a blanket pledge of residential mortgage loans to a detailed loan listing requirement. Our borrowing capacity under the detailed loan listing requirement is based on the market value of the underlying pledged loans rather than the unpaid principal balance of the pledged loans. The listing requirement also increases the level of collateral required for borrowings.

We also secured federal funds borrowing lines from correspondent banks totaling \$5.0 million on a secured basis. Management believes our sources of liquidity are adequate to meet expected cash needs for the foreseeable future, however, the availability of these lines could be affected by our financial position. We are also subject to FDIC interest rate restrictions for deposits. As such, we are permitted to offer up to the "national rate" plus 75 basis points as published weekly by the FDIC.

We use cash to pay dividends on common stock, if and when declared by the Board of Directors, and to service debt. The main sources of funding include dividends paid by PBI Bank, management fees received from PBI Bank and affiliated banks and financing obtained in the capital markets. During 2011, Porter Bancorp contributed \$13.1 million to its subsidiary, PBI Bank, which substantially decreased its liquid assets. The contribution was made to strengthen the Bank's capital in an effort to help it comply with its capital ratio requirements under the consent order. Liquid assets decreased from \$20.3 million at December 31, 2010, to \$4.9 million at December 31, 2011, and to \$3.5 million at December 31, 2012. Since the Bank is unlikely to be in a position to pay dividends to the parent company for the foreseeable future, cash inflows for the parent are limited to earnings on investment securities, sales of investment securities, and interest on deposits with the Bank. These cash inflows along with the liquid assets held at December 31, 2012, are needed to cover ongoing operating expenses of the parent company which have been reduced and are budgeted at \$1.1 million for 2013. Parent company liquidity could be improved if a capital raise was accomplished. See the "Supervision-Porter Bancorp-Dividends" section of Item 1. "Business" and the "Dividends" section of Item 5. "Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities" of this Annual Report on Form 10-K.

## Capital

In the fourth quarter of 2011, we began deferring the payment of regular quarterly cash dividends on our Series A Preferred Stock issued to the U.S. Treasury. If we defer dividend payments for six quarters, the holder of our Series A Preferred Stock (currently the U.S. Treasury) would then have the right to appoint representatives to our Board of Directors. We will continue to accrue any deferred dividends, which will be deducted from income to common shareholders for financial statement purposes.

In addition, effective with the fourth quarter of 2011, we began deferring interest payments on our junior subordinated notes with resulted in a deferral of distributions on our trust preferred securities. Therefore, we will not be able to pay cash dividends on our common stock until such time that we have paid all deferred distributions on our trust preferred securities.

Stockholders' equity decreased \$35.3 million to \$47.2 million at December 31, 2012, compared with \$83.8 million at December 31, 2011. The decrease was due to the 2012 net loss and to dividends accrued on our Series A Preferred Stock.

In 2010, we completed a \$32 million private placement to accredited investors. Following completion of the transactions involved, Porter Bancorp had issued (i) 2,465,569 shares of common stock, (ii) 317,042 shares of Series C Preferred Stock and (iii) warrants to purchase to purchase 1,163,045 shares of non-voting common stock at a price of \$11.50 per share.

The Series C Preferred Stock has no voting rights (except when required by law), has a liquidation preference over our common stock, and dividend rights equivalent to our common stock. Each share of Series C Preferred Stock automatically converts into 1.05 shares of common stock at such time as, after giving effect to the automatic conversion, the holder of the Series C Preferred Stock (together with its affiliates and any other persons with which it is acting in concert or whose holdings would otherwise be required to be aggregated for purposes of federal banking law) beneficially holds, directly or indirectly, less than 9.9% of the number of shares of common stock then issued and outstanding.

The warrants are exercisable into non-voting common stock until they expire on September 16, 2015. The non-voting common stock has no voting rights (except when required by law), but otherwise has the same dividend and other rights as our common stock. Upon issuance, each share of non-voting common stock automatically converts into 1.05 shares of common stock at such time as, after giving effect to the automatic conversion, the holder of the non-voting common stock (together with its affiliates and any other persons with which it is acting in concert or whose holdings would otherwise be required to be aggregated for purposes of federal banking law) holds, directly or indirectly, beneficially less than 9.9% of the number of shares of common stock then issued and outstanding.

On November 21, 2008, we issued to the U.S. Treasury, in exchange for aggregate consideration of \$35.0 million, 35,000 shares of our Series A Preferred Stock and a warrant to purchase up to 330,561 shares of our common stock for \$15.88 per share. The warrant is immediately exercisable and has a 10-year term. The Series A Preferred Stock qualifies as Tier 1 capital and pays cumulative cash dividends quarterly at an annual rate of 5% for the first five years, and 9% thereafter. The Series A Preferred Stock is non-voting (except when required by law) and after issuance may be redeemed by the Company at \$1,000 per share plus accrued unpaid dividends. Dividends accrued and unpaid on our Series A Preferred Stock, and interest accrued and unpaid on those dividends, totaled \$2.5 million at December 31, 2012.

Kentucky banking laws limit the amount of dividends that may be paid to a holding company by its subsidiary banks without prior approval. These laws limit the amount of dividends that may be paid in any calendar year to current year's net income, as defined in the laws, combined with the retained net income of the preceding two years, less any dividends declared during those periods. During 2013, the amount available to be paid by PBI Bank to Porter Bancorp would be 2013 earnings to date. However, PBI Bank has agreed with its primary regulators to obtain their written consent prior to declaring or paying any future dividends.

Each of the federal bank regulatory agencies has established risk-based capital requirements for banking organizations. See Item 1. Business – Supervision and Regulation – Porter Bancorp – Capital Adequacy Requirements and PBI Bank – Capital Requirements. In addition, PBI Bank has agreed with its primary regulators to maintain a ratio of total capital to total risk-weighted assets (“total risk-based capital ratio”) of at least 12.0%, and a ratio of Tier 1 capital to total assets (“leverage ratio”) of 9.0%.

The following table shows the ratios of Tier 1 capital and total capital to risk-adjusted assets and the leverage ratios for Porter Bancorp and PBI Bank at December 31, 2012:

	<u>Regulatory Minimums</u>	<u>Well- Capitalized Minimums</u>	<u>Minimum Capital Ratios Under Consent Order</u>	<u>Porter Bancorp</u>	<u>PBI Bank</u>
Tier 1 Capital	4.0%	6.0%	N/A	6.46%	7.71%
Total risk-based capital	8.0	10.0	12.0%	9.81	9.82
Tier 1 leverage ratio	4.0	5.0	9.0	4.50	5.37

At December 31, 2012, PBI Bank’s Tier 1 leverage ratio declined to 5.37% which is below the 9% minimum capital ratio required by the Consent Order and its total risk-based capital ratio declined to 9.82% which is below the 12% minimum capital ratio required by the Consent Order. Bank regulatory agencies can exercise discretion when an institution does not maintain minimum capital levels or meet the other terms of a consent order. The agencies may initiate changes in management, issue mandatory directives, impose monetary penalties or refrain from formal sanctions, depending on individual circumstances. Any action taken by bank regulatory agencies could damage our reputation and have a material adverse effect on our business.

See Footnote 2, “Going Concern Considerations and Future Plans”, to the financial statements for additional information.

#### **Off Balance Sheet Arrangements**

In the normal course of business, we enter into various transactions, which, in accordance with GAAP, are not included in our consolidated balance sheets. We enter into these transactions to meet the financing needs of our customers. These transactions include commitments to extend credit and standby letters of credit, which involve, to varying degrees, elements of credit risk and interest rate risk in excess of the amounts recognized in the consolidated balance sheets.

Our commitments associated with outstanding standby letters of credit and commitments to extend credit as of December 31, 2012 are summarized below. Since commitments associated with letters of credit and commitments to extend credit may expire unused, the amounts shown do not necessarily reflect our actual future cash funding requirements:

	<u>One year or less</u>	<u>More than 1 year but less than 3 years</u>	<u>3 years or more but less than 5 years</u>	<u>5 years or more</u>	<u>Total</u>
	(dollars in thousands)				
Commitments to extend credit	\$ 25,418	\$ 11,356	\$ 1,993	\$ 14,104	\$ 52,871
Standby letters of credit	2,261	—	—	—	2,261
Total	<u>\$ 27,679</u>	<u>\$ 11,356</u>	<u>\$ 1,993</u>	<u>\$ 14,104</u>	<u>\$ 55,132</u>

**Standby Letters of Credit** – Standby letters of credit are written conditional commitments we issue to guarantee the performance of a borrower to a third party. If the borrower does not perform in accordance with the terms of the agreement with the third party, we would be required to fund the commitment. The maximum potential amount of future payments we could be required to make is represented by the contractual amount of the commitment. If the commitment is funded, we would be entitled to seek recovery from the borrower. Our policies generally require that standby letter of credit arrangements contain security and debt covenants similar to those contained in loan agreements.

**Commitments to Extend Credit** – We enter into contractual commitments to extend credit, normally with fixed expiration dates or termination clauses, at specified rates and for specific purposes. Substantially all of our commitments to extend credit are contingent upon borrowers maintaining specific credit standards at the time of loan funding. We minimize our exposure to loss under these commitments by subjecting them to credit approval and monitoring procedures.

## Contractual Obligations

The following table summarizes our contractual obligations and other commitments to make future payments as of December 31, 2012:

	<u>One year or less</u>	<u>More than 1 year but less than 3 years</u>	<u>3 years or more but less than 5 years</u>	<u>5 years or more</u>	<u>Total</u>
(dollars in thousands)					
Time deposits	\$ 409,593	\$ 326,027	\$ 24,868	\$ 85	\$ 760,573
FHLB borrowing (1)	1,125	1,398	1,184	1,897	5,604
Subordinated capital note	900	1,800	1,800	2,475	6,975
Junior subordinated debentures	—	—	—	25,000	25,000
Total	<u>\$ 411,618</u>	<u>\$ 329,225</u>	<u>\$ 27,852</u>	<u>\$ 29,457</u>	<u>\$ 798,152</u>

(1) Fixed rate mortgage-matched borrowings with rates ranging from 0% to 5.25%, and maturities ranging from 2013 through 2033, averaging 3.21%.

## Impact of Inflation and Changing Prices

The financial statements and related data presented herein have been prepared in accordance with U.S. generally accepted accounting principles, which require the measurement of financial position and operating results in historical dollars without considering changes in the relative purchasing power of money over time due to inflation.

We have an asset and liability structure that is essentially monetary in nature. As a result, interest rates have a more significant impact on our performance than the effects of general levels of inflation. Periods of high inflation are often accompanied by relatively higher interest rates, and periods of low inflation are accompanied by relatively lower interest rates. As market interest rates rise or fall in relation to the rates earned on our loans and investments, the value of these assets decreases or increases respectively.

## Item 7A. Quantitative and Qualitative Disclosures About Market Risk

To minimize the volatility of net interest income and exposure to economic loss that may result from fluctuating interest rates, we manage our exposure to adverse changes in interest rates through asset and liability management activities within guidelines established by our Asset Liability Committee (“ALCO”). The ALCO, which is comprised of senior management representatives, has the responsibility for approving and ensuring compliance with asset/liability management policies. Interest rate risk is the exposure to adverse changes in the net interest income as a result of market fluctuations in interest rates. The ALCO, on an ongoing basis, monitors interest rate and liquidity risk in order to implement appropriate funding and balance sheet strategies. Management considers interest rate risk to be our most significant market risk.

We utilize an earnings simulation model to analyze net interest income sensitivity. We then evaluate potential changes in market interest rates and their subsequent effects on net interest income. The model projects the effect of instantaneous movements in interest rates of both 100 and 200 basis points that are sustained for one year. Assumptions based on the historical behavior of our deposit rates and balances in relation to changes in interest rates are also incorporated into the model. These assumptions are inherently uncertain and, as a result, the model cannot precisely measure future net interest income or precisely predict the impact of fluctuations in market interest rates on net interest income. Actual results will differ from the model’s simulated results due to timing, magnitude and frequency of interest rate changes as well as changes in market conditions and the application and timing of various management strategies.

Our interest sensitivity profile was asset sensitive at December 31, 2012 and December 31, 2011. Given an instantaneous 100 basis point increase in interest rates our base net interest income would increase by an estimated 4.0% at December 31, 2012 compared with an increase of 5.8% at December 31, 2011.

The following table indicates the estimated impact on net interest income under various interest rate scenarios for the year ended December 31, 2012, as calculated using the static shock model approach:

<u>Change in Interest Rates</u>	<u>Change in Future Net Interest Income</u>	
	<u>Dollar Change</u>	<u>Percentage Change</u>
(dollars in thousands)		
+ 200 basis points	\$ 2,883	8.11%
+ 100 basis points	1,460	4.11

We did not run a model simulation for declining interest rates as of December 31, 2012, because the Federal Reserve effectively lowered the federal funds target rate between 0.00% to 0.25% in December 2008. Therefore, further short-term rate reductions are not practical. As we implement strategies to mitigate the risk of rising interest rates in the future, these strategies will lessen our forecasted “base case” net interest income in the event of no interest rate changes.





Our interest sensitivity at any point in time will be affected by a number of factors. These factors include the mix of interest sensitive assets and liabilities as well as their relative pricing schedules. It is also influenced by market interest rates, deposit growth, loan growth, decay rates and prepayment speed assumptions.

The following table sets forth the amounts of our interest-earning assets and interest-bearing liabilities outstanding at December 31, 2012, which we anticipate, based upon certain assumptions, to reprice or mature in each of the future time periods shown. The projected repricing of assets and liabilities anticipates prepayments and scheduled rate adjustments, as well as contractual maturities under an interest rate unchanged scenario within the selected time intervals. While we believe such assumptions are reasonable, we cannot assure you that assumed repricing rates will approximate our actual future activity.

	Volume Subject to Repricing Within					Non-Interest Sensitive	Total
	0 – 90 Days	91 – 181 Days	182 – 365 Days	1 – 5 Years	Over 5 Years		
	(dollars in thousands)						
<b>Assets:</b>							
Federal funds sold and short-term investments	\$ 41,161	\$ —	\$ —	\$ —	\$ —	\$ —	\$ 41,161
Investment securities	23,607	7,647	11,291	56,537	65,459	13,935	178,476
FHLB stock	10,072	—	—	—	—	—	10,072
Loans held for sale	507	—	—	—	—	—	507
Loans, net of allowance	334,552	94,144	120,496	246,679	103,221	(56,680)	842,412
Fixed and other assets	—	—	—	—	—	90,003	90,003
Total assets	<u>\$ 409,899</u>	<u>\$ 101,791</u>	<u>\$ 131,787</u>	<u>\$ 303,216</u>	<u>\$ 168,680</u>	<u>\$ 47,258</u>	<u>\$ 1,162,631</u>
<b>Liabilities and Stockholders' Equity</b>							
Interest-bearing checking, savings, and money market accounts	\$ 190,176	\$ —	\$ —	\$ —	\$ —	\$ —	\$ 190,176
Certificates of deposit	113,009	128,822	164,875	352,434	1,433	—	760,573
Borrowed funds	34,897	273	459	3,062	1,522	—	40,213
Other liabilities	—	—	—	—	—	124,479	124,479
Stockholders' equity	—	—	—	—	—	47,190	47,190
Total liabilities and stockholders' equity	<u>\$ 338,082</u>	<u>\$ 129,095</u>	<u>\$ 165,334</u>	<u>\$ 355,496</u>	<u>\$ 2,955</u>	<u>\$ 171,669</u>	<u>\$ 1,162,631</u>
Period gap	<u>\$ 71,817</u>	<u>\$ (27,304)</u>	<u>\$ (33,547)</u>	<u>\$ (52,280)</u>	<u>\$ 165,725</u>		
Cumulative gap	<u>\$ 71,817</u>	<u>\$ 44,513</u>	<u>\$ 10,966</u>	<u>\$ (41,314)</u>	<u>\$ 124,411</u>		
Period gap to total assets	<u>6.18%</u>	<u>(2.35%)</u>	<u>(2.89%)</u>	<u>(4.50%)</u>	<u>14.25%</u>		
Cumulative gap to total assets	<u>6.18%</u>	<u>3.83%</u>	<u>0.94%</u>	<u>(3.55%)</u>	<u>10.40%</u>		
Cumulative interest-earning assets to cumulative interest-bearing liabilities	<u>121.24%</u>	<u>109.53%</u>	<u>101.73%</u>	<u>95.82%</u>	<u>112.55%</u>		

Our one-year cumulative gap position as of December 31, 2012 was positive \$11.0 million or 0.9% of assets. This is a one-day position that is continually changing and is not necessarily indicative of our position at any other time. Any gap analysis has inherent shortcomings because certain assets and liabilities may not move proportionally as interest rates change.

**Item 8. Financial Statements and Supplementary Data**

The following consolidated financial statements and reports are included in this section:

Management's Report on Internal Control Over Financial Reporting

Report of Independent Registered Public Accounting Firm

Consolidated Balance Sheets as of December 31, 2012 and 2011

Consolidated Statements of Operations for the Years Ended December 31, 2012, 2011, and 2010

Consolidated Statements of Comprehensive Loss for the Years Ended December 31, 2012, 2011, and 2010

Consolidated Statements of Change in Stockholders' Equity for the Years Ended  
December 31, 2012, 2011, and 2010

Consolidated Statements of Cash Flows for the Years Ended December 31, 2012, 2011, and 2010

Notes to Consolidated Financial Statements



## MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

The Management of Porter Bancorp, Inc. (the "Company") is responsible for the preparation, integrity, and fair presentation of the Company's annual consolidated financial statements. All information has been prepared in accordance with U.S. generally accepted accounting principles and, as such, includes certain amounts that are based on Management's best estimates and judgments.

Management is responsible for establishing and maintaining adequate internal control over financial reporting presented in conformity with U.S. generally accepted accounting principles. Internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the Company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with U.S. generally accepted accounting principles, and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the Company's assets that could have a material effect on the financial statements.

Two of the objectives of internal control are to provide reasonable assurance to Management and the Board of Directors that transactions are properly authorized and recorded in our financial records, and that the preparation of the Company's financial statements and other financial reporting is done in accordance with U.S. generally accepted accounting principles.

Management has made its own assessment of the effectiveness of the Company's internal control over financial reporting as of December 31, 2012, in relation to the criteria described in the report, Internal Control — Integrated Framework, issued by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO"). Based on our assessment, Management concludes that as of December 31, 2012, the Company's internal control over financial reporting is effective based on those criteria.

There are inherent limitations in the effectiveness of internal control, including the possibility of human error and the circumvention or overriding of controls. Accordingly, even effective internal control can provide only reasonable assurance with respect to reliability of financial statements. Furthermore, the effectiveness of internal control can vary with changes in circumstances. Based on its assessment, Management believes that as of December 31, 2012, the Company's internal control was effective in achieving the objectives stated above.

/s/ Maria L. Bouvette

Maria L. Bouvette  
Chairman and  
Chief Executive Officer

/s/ Phillip W. Barnhouse

Phillip W. Barnhouse  
Chief Financial Officer

February 28, 2013



## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Porter Bancorp, Inc.  
Louisville, Kentucky

We have audited the accompanying consolidated balance sheets of Porter Bancorp, Inc. as of December 31, 2012 and 2011, and the related consolidated statements of operations, changes in stockholders' equity and comprehensive income, and cash flows for each of the three years in the period ended December 31, 2012. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Porter Bancorp, Inc. as of December 31, 2012 and 2011, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2012, in conformity with U.S. generally accepted accounting principles.

The accompanying consolidated financial statements have been prepared assuming the Company will continue as a going concern. As discussed in Note 2 to the consolidated financial statements, the Company has incurred substantial losses in 2012, 2011 and 2010, largely as a result of asset impairments. In addition, the Company's bank subsidiary is not in compliance with a regulatory enforcement order issued by its primary federal regulator requiring, among other things, increased minimum regulatory capital ratios. Additional significant asset impairments or continued failure to comply with the regulatory enforcement order may result in additional adverse regulatory action. These events raise substantial doubt about the Company's ability to continue as a going concern. Management's plans with regard to these matters are also discussed in Note 2 to the consolidated financial statements. The consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty.

Crowe Horwath, LLP

Louisville, Kentucky  
February 28, 2013

**PORTER BANCORP, INC.**  
**CONSOLIDATED BALANCE SHEETS**  
**December 31,**  
(Dollar amounts in thousands except share data)

	<b>2012</b>	<b>2011</b>
<b>Assets</b>		
Cash and due from financial institutions	\$ 46,512	\$ 104,680
Federal funds sold	3,060	1,282
Cash and cash equivalents	49,572	105,962
Securities available for sale	178,476	158,833
Mortgage loans held for sale	507	694
Loans, net of allowance of \$56,680 and \$52,579, respectively	842,412	1,083,444
Premises and equipment	20,805	21,541
Other real estate owned	43,671	41,449
Federal Home Loan Bank stock	10,072	10,072
Bank owned life insurance	8,398	8,106
Accrued interest receivable and other assets	8,718	25,323
<b>Total assets</b>	<b>\$ 1,162,631</b>	<b>\$ 1,455,424</b>
<b>Liabilities and Stockholders' Equity</b>		
Deposits		
Non-interest bearing	\$ 114,310	\$ 111,118
Interest bearing	950,749	1,212,645
Total deposits	1,065,059	1,323,763
Repurchase agreements	2,634	1,738
Federal Home Loan Bank advances	5,604	7,116
Accrued interest payable and other liabilities	10,169	7,628
Subordinated capital note	6,975	7,650
Junior subordinated debentures	25,000	25,000
Total liabilities	1,115,441	1,372,895
Commitments and contingent liabilities (Note 18)	—	—
Stockholders' equity		
Preferred stock, no par, 1,000,000 shares authorized		
Series A - 35,000 issued and outstanding; Liquidation preference of \$35 million at December 31, 2012	34,840	34,661
Series C - 317,042 issued and outstanding; Liquidation preference of \$3.6 million at December 31, 2012	3,283	3,283
Common stock, no par, 86,000,000 shares authorized, 12,002,421 and 11,824,472 shares issued and outstanding, respectively	112,236	112,236
Additional paid-in capital	20,283	19,841
Retained deficit	(126,517)	(91,656)
Accumulated other comprehensive income	3,065	4,164
Total stockholders' equity	47,190	82,529
<b>Total liabilities and stockholders' equity</b>	<b>\$ 1,162,631</b>	<b>\$ 1,455,424</b>

See accompanying notes.

**PORTER BANCORP, INC.**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
**Years Ended December 31,**  
(Dollar amounts in thousands except per share data)

	<u>2012</u>	<u>2011</u>	<u>2010</u>
Interest income			
Loans, including fees	\$ 52,918	\$ 67,679	\$ 77,559
Taxable securities	3,333	4,008	7,338
Tax exempt securities	887	1,123	854
Federal funds sold and other	591	744	656
	<u>57,729</u>	<u>73,554</u>	<u>86,407</u>
Interest expense			
Deposits	14,623	20,147	25,392
Federal Home Loan Bank advances	207	537	2,015
Junior subordinated debentures	671	632	639
Subordinated capital note	266	283	311
Federal funds purchased and other	7	440	484
	<u>15,774</u>	<u>22,039</u>	<u>28,841</u>
Net interest income	41,955	51,515	57,566
Provision for loan losses	40,250	62,600	30,100
Net interest income (loss) after provision for loan losses	1,705	(11,085)	27,466
Non-interest income			
Service charges on deposit accounts	2,239	2,609	2,984
Income from fiduciary activities	1,177	993	987
Bank card interchange fees	727	668	606
Other real estate owned rental income	420	200	121
Secondary market brokerage fees	94	219	327
Net gain on sales of loans originated for sale	338	713	554
Net gain on sales of securities	3,236	1,108	5,152
Other-than-temporary impairment loss			
Total impairment loss	—	(41)	(597)
Loss recognized in other comprehensive income	—	—	—
Net impairment loss recognized in earnings	—	(41)	(597)
Other	1,359	1,364	1,448
	<u>9,590</u>	<u>7,833</u>	<u>11,582</u>
Non-interest expense			
Salaries and employee benefits	16,648	15,218	14,903
Occupancy and equipment	3,642	3,729	4,095
Goodwill impairment	—	23,794	—
Other real estate owned expense	10,549	47,525	16,254
FDIC insurance	2,835	3,470	2,971
Loan collection expense	2,442	2,509	908
State franchise tax	2,174	2,228	2,172
Professional fees	1,985	1,392	1,067
Communications	710	678	737
Borrowing prepayment fees	—	486	—
Postage and delivery	454	485	722
Advertising	154	314	408
Other	2,699	2,445	2,241
	<u>44,292</u>	<u>104,273</u>	<u>46,478</u>
Loss before income taxes	(32,997)	(107,525)	(7,430)
Income tax expense (benefit)	(65)	(218)	(3,046)
Net loss	(32,932)	(107,307)	(4,384)
Less:			
Dividends on preferred stock	(1,750)	(1,750)	(1,810)
Accretion on Series A preferred stock	(179)	(177)	(177)
(Earnings) loss allocated to participating securities	1,429	4,080	184
Net loss attributable to common shareholders	<u>\$ (33,432)</u>	<u>\$ (105,154)</u>	<u>\$ (6,187)</u>
Basic loss per common share	<u>\$ (2.85)</u>	<u>\$ (8.98)</u>	<u>\$ (0.60)</u>
Diluted loss per common share	<u>\$ (2.85)</u>	<u>\$ (8.98)</u>	<u>\$ (0.60)</u>

See accompanying notes.

**PORTER BANCORP, INC.**  
**CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS**  
**Years Ended December 31,**  
(in thousands)

	<u>2012</u>	<u>2011</u>	<u>2010</u>
Net loss	\$ (32,932)	\$ (107,307)	\$ (4,384)
Other comprehensive income (loss):			
Unrealized gain (loss) on securities:			
Unrealized gain (loss) arising during the period	1,545	4,162	4,553
Reclassification of other than temporary impairment	—	41	597
Reclassification of amount realized through sales	<u>(3,236)</u>	<u>(1,108)</u>	<u>(5,152)</u>
Included in net loss	(1,691)	3,095	(2)
Tax effect	<u>592</u>	<u>(1,083)</u>	<u>1</u>
Net of tax	<u>(1,099)</u>	<u>2,012</u>	<u>(1)</u>
Comprehensive loss	<u>\$ (34,031)</u>	<u>\$ (105,295)</u>	<u>\$ (4,385)</u>

See accompanying notes.





comprehensive income, net of taxes	—	—	—	—	—	—	—	—	—	—	2,012	2,012
Dividends 5% on Series A preferred stock	—	—	—	—	—	—	—	—	—	(1,750)	—	(1,750)
Dividends on Series C preferred stock (\$0.02 per share)	—	—	—	—	—	—	—	—	—	(7)	—	(7)
Accretion of Series A preferred stock discount	—	—	—	—	—	177	—	—	—	(177)	—	—
Cash dividends declared (\$0.02 per share)	—	—	—	—	—	—	—	—	—	(237)	—	(237)
<b>Balances, December 31, 2011</b>	<b>11,824,472</b>	<b>35,000</b>	<b>—</b>	<b>317,042</b>	<b>112,236</b>	<b>34,661</b>	<b>—</b>	<b>3,283</b>	<b>19,841</b>	<b>(91,656)</b>	<b>4,164</b>	<b>82,529</b>
Issuance of unvested stock	191,140	—	—	—	—	—	—	—	—	—	—	—
Forfeited unvested stock	(13,191)	—	—	—	—	—	—	—	—	—	—	—
Stock-based compensation expense	—	—	—	—	—	—	—	—	442	—	—	442
Net loss	—	—	—	—	—	—	—	—	—	(32,932)	—	(32,932)
Changes in accumulated other comprehensive income, net of taxes	—	—	—	—	—	—	—	—	—	—	(1,099)	(1,099)
Dividends 5% on Series A preferred stock	—	—	—	—	—	—	—	—	—	(1,750)	—	(1,750)
Accretion of Series A preferred stock discount	—	—	—	—	—	179	—	—	—	(179)	—	—
<b>Balances, December 31, 2012</b>	<b><u>12,002,421</u></b>	<b><u>35,000</u></b>	<b><u>—</u></b>	<b><u>317,042</u></b>	<b><u>\$ 112,236</u></b>	<b><u>\$ 34,840</u></b>	<b><u>\$ —</u></b>	<b><u>\$ 3,283</u></b>	<b><u>\$ 20,283</u></b>	<b><u>\$(126,517)</u></b>	<b><u>\$ 3,065</u></b>	<b><u>\$ 47,190</u></b>

See accompanying notes.

**PORTER BANCORP, INC.**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**Years Ended December 31,**  
(in thousands)

	<u>2012</u>	<u>2011</u>	<u>2010</u>
<b>Cash flows from operating activities</b>			
Net loss	\$ (32,932)	\$ (107,307)	\$ (4,384)
Adjustments to reconcile net loss to net cash from operating activities			
Depreciation and amortization	2,288	2,389	2,926
Provision for loan losses	40,250	62,600	30,100
Net amortization (accretion) on securities	3,335	1,552	(9)
Goodwill impairment charge	—	23,794	—
Stock-based compensation expense	442	436	467
Deferred income taxes (benefit)	—	12,958	(7,898)
Net gain on sales of loans originated for sale	(338)	(713)	(554)
Loans originated for sale	(16,365)	(24,881)	(28,165)
Proceeds from sales of loans originated for sale	16,827	24,649	28,467
Net loss on sales of other real estate owned	1,672	8,889	565
Net write-down of other real estate owned	7,154	34,874	14,062
Net realized gain on sales of investment securities	(3,236)	(1,067)	(4,555)
Earnings on bank owned life insurance	(292)	(301)	(296)
Net change in accrued interest receivable and other assets	16,150	(7,062)	3,667
Net change in accrued interest payable and other liabilities	791	(575)	(485)
Net cash from operating activities	<u>35,746</u>	<u>30,235</u>	<u>33,908</u>
<b>Cash flows from investing activities</b>			
Purchases of available-for-sale securities	(162,840)	(123,609)	(55,750)
Sales of available-for-sale securities	93,199	50,318	96,808
Maturities and prepayments of available-for-sale securities	48,800	23,378	25,917
Proceeds from sale of other real estate owned	21,940	14,142	15,284
Improvements to other real estate owned	(1)	(1,650)	(1,947)
Loan originations and payments, net	167,272	92,190	6,160
Purchases of premises and equipment, net	(511)	(332)	(368)
Net cash from investing activities	<u>167,859</u>	<u>54,437</u>	<u>86,104</u>
<b>Cash flows from financing activities</b>			
Net change in deposits	(258,704)	(143,905)	(62,428)
Net change in repurchase agreements	896	(9,878)	99
Repayment of Federal Home Loan Bank advances	(1,512)	(32,906)	(307,958)
Advances from Federal Home Loan Bank	—	25,000	240,000
Repayment of subordinated capital note	(675)	(900)	(450)
Issuance of preferred stock and warrants, net	—	—	11,064
Issuance of common stock and warrants, net	—	—	19,476
Cash dividends paid on preferred stock	—	(1,319)	(1,847)
Cash dividends paid on common stock	—	(237)	(4,706)
Net cash from financing activities	<u>(259,995)</u>	<u>(164,145)</u>	<u>(106,750)</u>
Net change in cash and cash equivalents	(56,390)	(79,473)	13,262
Beginning cash and cash equivalents	105,962	185,435	172,173
Ending cash and cash equivalents	<u>\$ 49,572</u>	<u>\$ 105,962</u>	<u>\$ 185,435</u>
<b>Supplemental cash flow information:</b>			
Interest paid	\$ 15,402	\$ 22,218	\$ 29,637
Income taxes paid (refunded)	(12,726)	2,000	4,850
<b>Supplemental non-cash disclosure:</b>			
Transfer from loans to other real estate	\$ 33,528	\$ 41,917	\$ 90,787
Financed sales of other real estate owned	541	11,848	9,736
5% Stock dividend	—	—	5,872

See accompanying notes .

**PORTER BANCORP, INC. AND SUBSIDIARY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**December 31, 2012, 2011 and 2010**

**NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Nature of Operations and Principles of Consolidation** – The consolidated financial statements include Porter Bancorp, Inc. (Company or PBI) and its subsidiary, PBI Bank (Bank). The Company owns a 100% interest in the Bank.

The Company provides financial services through its offices in Central Kentucky and Louisville. Its primary deposit products are checking, savings, and term certificate accounts, and its primary lending products are residential mortgage, commercial, and real estate loans. Substantially all loans are collateralized by specific items of collateral including business assets, commercial real estate, and residential real estate. Commercial loans are expected to be repaid from cash flow from operations of businesses. There are no significant concentrations of loans to any one industry or customer. However, customers' ability to repay their loans is dependent on the real estate and general economic conditions in the area. Other financial instruments which potentially represent concentrations of credit risk include deposit accounts in other financial institutions and federal funds sold. The Company also provides trust services.

**Use of Estimates** – To prepare financial statements in conformity with U.S. generally accepted accounting principles, management makes estimates and assumptions based on available information. These estimates and assumptions affect the amounts reported in the financial statements and the disclosures provided, and future results could differ. The allowance for loan losses, goodwill and other intangible assets, fair value of other real estate owned, stock compensation, deferred tax assets, and fair values of financial instruments are particularly subject to change.

**Cash Flows** – Cash and cash equivalents include cash, deposits with other financial institutions under 90 days, and federal funds sold. Net cash flows are reported for customer and loan deposit transactions, interest-bearing deposits in other financial institutions, and federal funds purchased and repurchase agreements.

**Securities** – Debt securities are classified as available-for-sale when they might be sold before maturity. Equity securities with readily determined fair values are classified as available-for-sale. Securities available for sale are carried at fair value, with unrealized holding gains and losses reported in other comprehensive income.

Interest income includes amortization of purchase premium or discount. Premiums and discounts on securities are amortized on the level-yield method anticipating prepayments on mortgage backed securities. Gains and losses on sales are recorded on the trade date and determined using the specific identification method.

Management evaluates securities for other-than-temporary impairment (“OTTI”) on at least a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation. For securities in an unrealized loss position, management considers the extent and duration of the unrealized loss, and the financial condition and near-term prospects of the issuer. Management also assesses whether it intends to sell, or it is more likely than not that it will be required to sell, a security in an unrealized loss position before recovery of its amortized cost basis. If either of the criteria regarding intent or requirement to sell is met, the entire difference between amortized cost and fair value is recognized as impairment through earnings. For debt securities that do not meet the aforementioned criteria, the amount of impairment is split into two components as follows: 1) OTTI related to credit loss, which must be recognized in the income statement and 2) other-than-temporary impairment (OTTI) related to other factors, which is recognized in other comprehensive income. The credit loss is defined as the difference between the present value of the cash flows expected to be collected and the amortized cost basis. For equity securities, the entire amount of impairment is recognized through earnings.

**Loans Held for Sale** – Mortgage loans originated and intended for sale in the secondary market are carried at the lower of aggregate cost or fair value, as determined by outstanding commitments from investors. Net unrealized losses, if any, are recorded as a valuation allowance and charged to earnings.

Mortgage loans held for sale are generally sold with servicing rights released. If sold with servicing retained, the carrying value of mortgage loans sold is reduced by the amount allocated to the servicing right. Gains and losses on sales of mortgage loans are based on the difference between the selling price and the carrying value of the related loan sold.

Mortgage banking derivatives used in the ordinary course of business consist of mandatory forward sales contracts and rate lock loan commitments. Forward contracts represent future commitments to deliver loans at a specified price and date and are used to manage interest rate risk on loan commitments and mortgage loans held for sale. Rate lock commitments represent commitments to fund loans at a specific rate. These derivatives involve underlying items, such as interest rates, and are designed to transfer risk. Substantially all of these instruments expire within 60 days from the date of issuance. Notional amounts are amounts on which calculations and payments are based, but which do not represent credit exposure, as credit exposure is limited to the amounts required to be received or paid.

We adopted FASB ASC topic 815, “*Derivative and Hedging*” during the first quarter of 2009. Our commitments to deliver loans and our rate lock loan commitments were insignificant at year end.

**Loans** – Loans that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are reported at the principal balance outstanding, net of deferred loan fees and costs, and an allowance for loan losses. Interest income is accrued on the unpaid principal balance. Loan origination fees, net of certain direct origination costs, are deferred and recognized in interest income using the level-yield method without anticipating prepayments. The recorded investment in loans includes the outstanding principal balance and unamortized deferred origination costs and fees.

Interest income on mortgage and commercial loans is discontinued at the time the loan is 90 days delinquent unless the loan is well collateralized and in process of collection. Consumer and credit card loans are typically charged off no later than 90 days past due. Past due status is based on the contractual terms of the loan. In all cases, loans are placed on non-accrual or charged off at an earlier date if collection of principal or interest is considered doubtful.

All interest accrued but not received for loans placed on non-accrual is reversed against interest income. Interest received on such loans is accounted for on the cash-basis or cost-recovery method, until qualifying for return to accrual. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

**Allowance for Loan Losses** – The allowance for loan losses is a valuation allowance for probable incurred credit losses. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance. We estimate the allowance balance required using past loan loss experience, the nature and volume of the portfolio, information about specific borrower situations and estimated collateral values, economic conditions, and other factors. Allocations of the allowance may be made for specific loans, but the entire allowance is available for any loan that, in our judgment, should be charged off.

The allowance consists of specific and general components. The specific component relates to loans that are individually classified as impaired. A loan is impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. Loans for which the terms have been modified resulting in a concession, and for which the borrower is experiencing financial difficulties, are considered troubled debt restructurings and classified as impaired.

Factors considered in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. We determine the significance of payment delays and payment shortfalls on case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower’s prior payment record, and the amount of the shortfall in relation to the principal and interest owed.

If a loan is impaired, a portion of the allowance is allocated so that the loan is reported, net, at the present value of estimated future cash flows using the loan’s existing rate or at the fair value of collateral if repayment is expected solely from the collateral. Large groups of smaller balance homogeneous loans, such as consumer and residential real estate loans, are collectively evaluated for impairment, and accordingly, they are not separately identified for impairment disclosures. Troubled debt restructurings are separately identified for impairment disclosures and are measured at the present value of estimated future cash flows using the loan’s effective rate at inception. If a troubled debt restructuring is considered to be a collateral dependent loan, the loan is reported, net, at the fair value of the collateral. For troubled debt restructurings that subsequently default, we determine the amount of reserve in accordance with the accounting policy for the allowance for loan losses.

The general component covers non-impaired loans and is based on historical loss experience adjusted for current factors. The historical loss experience is determined by portfolio segment and is based on our actual loss history experienced over the most recent three years with weighting towards the most recent periods. This actual loss experience is supplemented with other economic factors based on the risks present for each portfolio segment. These economic factors include consideration of the following: levels of and trends in delinquencies and impaired loans; levels of and trends in charge-offs and recoveries; trends in volume and terms of loans; effects of any changes in risk selection and underwriting standards; other changes in lending policies, procedures, and practices; experience, ability, and depth of lending management and other relevant staff; national and local economic trends and conditions; industry conditions; and effects of changes in credit concentrations. At year-end 2010, we increased our emphasis on historical loss experience and the qualitative factors discussed above that we believe are essential to assessing the general component of the reserve. We believe this added emphasis serves to ensure our estimates affecting the general component of the reserve most effectively parallel changing risks in the market in a timely fashion.

A portfolio segment is defined as the level at which an entity develops and documents a systematic methodology to determine its allowance for loan losses. We identified the following portfolio segments: commercial, commercial real estate, residential real estate, consumer, agricultural, and other.

- Commercial loans are dependent on the strength of the industries of the related borrowers and the success of their businesses. Commercial loans are advances for equipment purchases, or to provide working capital, or to meet other financing needs of business enterprises. These loans may be secured by accounts receivable, inventory, equipment or other business assets. Financial information is obtained from the borrowers to evaluate their ability to repay the loans.
- Commercial real estate loans are affected by the local commercial real estate market and the local economy. Commercial real estate loans include loans on properties occupied by the borrowers and on properties for commercial purposes. Construction and development loans are a component of this segment. These loans are generally secured by land under development or homes and commercial buildings under construction. Appraisals are obtained to support the loan amount. Financial information is obtained from the borrowers and/or the individual project to evaluate cash flows sufficiency to service the debt.
- Residential real estate loans are affected by the local residential real estate market, local economy, and, for variable rate mortgages, movement in indices tied to these loans. For owner occupied residential loans, the borrowers' repayment ability is evaluated through a review of credit scores and debt to income ratios. For non-owner occupied residential loans, such as rental real estate, financial information is obtained from the borrowers and/or the individual project to evaluate cash flows sufficiency to service the debt. Appraisals are obtained to support the loan amount.
- Consumer loans are dependent on local economies. Consumer loans are generally secured by consumer assets, but may be unsecured. We evaluate the borrowers' repayment ability through a review of credit scores and an evaluation of debt to income ratios.
- Agriculture loans are dependent on the industries tied to these loans and are generally secured by livestock, crops, and/or equipment, but may be unsecured. We evaluate the borrowers' repayment ability through a review of credit scores and an evaluation of debt to income ratios.
- Other loans include loans to municipalities, loans secured by stock, and overdrafts. For municipal loans, we evaluate the borrowers' revenue streams as well as ability to repay from general funds. For loans secured by stock, we evaluate the market value of the stock securing the loan in relation to the loan amount. Overdrafts are funded based on pre-established criteria related to the deposit account relationship.

We analyze all relevant risk characteristics for each portfolio segment and have determined that loans in each segment possess similar general risk characteristics that are analyzed in connection with our loan underwriting processes and procedures. In determining the allocated allowance, we utilize weighted average loss rates for the past three years most heavily weighting the current year. Commercial real estate loans are our largest segment and had the highest level of qualitative adjustments due to trends in our markets for underlying collateral values and risks related to tenant rents and for economic factors such as decreased sales demand, elevated inventory levels, and declining collateral values. Residential real estate loan considerations include macro factors such as unemployment rates, trends in vacancy rates, and home value trends. The commercial portfolio qualitative adjustments are related to industry concentrations and geographical market. Our agricultural, consumer, and other portfolios are less significant in terms of size and risk is assessed based on the smaller dollar size of these loans and the more geographical areas where the collateral is located.

**Transfers of Financial Assets** – Transfers of financial assets are accounted for as sales, when control over the assets has been relinquished. Control over transferred assets is deemed to be surrendered when the assets have been isolated from the Company, the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and the Company does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

**Other Real Estate Owned** – Assets acquired through or instead of loan foreclosure are initially recorded at fair value less estimated costs to sell when acquired, establishing a new cost basis. These assets are subsequently accounted for at the lower of cost or fair value, less estimated costs to sell. If fair value declines subsequent to foreclosure, a valuation allowance is recorded through expense. Costs after acquisition are expensed.

**Premises and Equipment** – Land is carried at cost. Premises and equipment are stated at cost less accumulated depreciation. Buildings and related components are depreciated using the straight-line method with useful lives ranging from 5 to 33 years. Furniture, fixtures and equipment are depreciated using the straight-line or accelerated method with useful lives ranging from 3 to 7 years.

**Federal Home Loan Bank (FHLB) Stock** – The Bank is a member of the FHLB system. Members are required to own a certain amount of stock based on the level of borrowings and other factors, and may invest in additional amounts. FHLB stock is carried at cost, classified as a restricted security, and periodically evaluated for impairment. Because this stock is viewed as long term investment, impairment is based on ultimate recovery of par value. Both cash and stock dividends are reported as income.



**Goodwill and Intangible Assets** – Goodwill resulting from business combinations prior to January 1, 2009, represents the excess of the purchase price over the fair value of the net assets of businesses acquired. Goodwill resulting from business combinations after January 1, 2009, is generally determined as the excess of the fair value of the consideration transferred, plus the fair value of any non-controlling interests in the acquiree, over the fair value of the net assets acquired and liabilities assumed as of the acquisition date. Goodwill and intangible assets acquired in a purchase business combination and determined to have an indefinite useful life are not amortized, but tested for impairment at least annually. Intangible assets with definite useful lives are amortized over their estimated useful lives to their estimated residual values. Intangible assets on our balance sheet, other than goodwill, have defined useful lives. The Company has selected November 30th as the date to perform the annual impairment test on goodwill unless events or changes in circumstances indicate potential impairment may have occurred between annual assessments. We assessed our goodwill for impairment during the second quarter of 2011 because our stock, which trades publicly on the NASDAQ, experienced a significant drop in value throughout the months of May and June 2011. Based on this analysis, we determined that our Goodwill was impaired and recorded an impairment charge of \$23.8 million in the quarter ended June 30, 2011. The impairment charge had no impact on the Company's liquidity, cash flows, or regulatory capital ratios. (See Note 7 for more specific disclosure.)

Other intangible assets consist of core deposit and trust account intangible assets arising from whole bank and branch acquisitions. They are initially measured at fair value and then are amortized on an accelerated or straight-line basis over their estimated useful lives, which range from 7 to 10 years.

**Bank Owned Life Insurance** – The Bank has purchased life insurance policies on certain key executives. Company owned life insurance is recorded at the amount that can be realized under the insurance contract at the balance sheet date, which is the cash surrender value adjusted for other charges or other amounts due that are probable at settlement.

**Long-Term Assets** – Premises and equipment, other intangible assets, and other long-term assets are reviewed for impairment when events indicate their carrying amount may not be recoverable from future undiscounted cash flows. If impaired, the assets are recorded at fair value.

**Repurchase Agreements** – Substantially all repurchase agreement liabilities represent amounts advanced by various customers. Securities are pledged to cover these liabilities, which are not covered by federal deposit insurance.

**Benefit Plans** – Employee 401(k) and profit sharing plan expense is the amount of matching contributions. Deferred compensation and supplemental retirement plan expense allocates the benefits over years of service.

**Stock-Based Compensation** – Compensation cost is recognized for stock options and unvested stock awards issued to employees, based on the fair value of these awards at the date of grant. A Black-Scholes model is utilized to estimate the fair value of stock options, while the market price of the Corporation's common stock at the date of grant is used for restricted stock awards. Compensation cost is recognized over the required service period, generally defined as the vesting period. For awards with graded vesting, compensation cost is recognized on a straight-line basis over the requisite service period for the entire award.

**Income Taxes** – Income tax expense is the total of the current year income tax due or refundable and the change in deferred tax assets and liabilities. Deferred tax assets and liabilities are the expected future tax amounts for the temporary differences between carrying amounts and tax bases of assets and liabilities, computed using enacted tax rates. A valuation allowance, if needed, reduces deferred tax assets to the amount expected to be realized.

A tax position is recognized as a benefit only if it is "more likely than not" that the tax position would be sustained in a tax examination, with a tax examination being presumed to occur. The amount recognized is the largest amount of tax benefit that is greater than 50% likely of being realized on examination. For tax positions not meeting the "more likely than not" test, no tax benefit is recorded. The Company recognizes interest and/or penalties related to income tax matters in income tax expense.

**Loan Commitments and Related Financial Instruments** – Financial instruments include off-balance sheet credit instruments, such as commitments to make loans and commercial letters of credit, issued to meet customer-financing needs. The face amount for these items represents the exposure to loss, before considering customer collateral or ability to repay. Such financial instruments are recorded when they are funded.

**Comprehensive Income** – Comprehensive income consists of net income and other comprehensive income. Other comprehensive income includes unrealized gains and losses on securities available for sale, which are also recognized as a separate component of equity.



**Equity** – Stock dividends in excess of 20% are reported by transferring the par value of the stock issued from retained earnings to common stock. Stock dividends for 20% or less are reported by transferring the fair value, as of the ex-dividend date, of the stock issued from retained earnings to common stock and additional paid-in capital. Fractional share amounts are paid in cash with a reduction in retained earnings.

**Preferred Stock** – Series A Preferred stock was issued in 2008 and is outstanding under the United States Department of the Treasury's Capital Purchase Program. Issued in conjunction with the Preferred Stock were common stock warrants. See Note 16 for a discussion of the terms and conditions of that transaction. The proceeds received in the offering were allocated on a pro rata basis to the Preferred Stock and the Warrants based on relative fair values. In estimating the fair value of the Warrants, the Company utilized the Black-Scholes model which includes assumptions regarding the Company's common stock prices, stock price volatility, dividend yield, the risk free interest rate and the estimated life of the Warrant. The fair value of the Preferred Stock was determined using a discounted cash flow methodology. The value assigned to the Preferred Stock will be amortized up to the \$35.0 million liquidation value of such preferred stock, with the cost of such amortization being reported as additional preferred stock dividends. Dividends are accrued quarterly. Quarterly cash payment of dividends was deferred effective with the fourth quarter of 2011. (See Note 16 for more specific disclosure.)

Series B and C Preferred stock were issued in 2010 and Series C Preferred stock remains outstanding. See Note 16 for a discussion of the terms and conditions of this transaction.

**Earnings Per Common Share** – Basic earnings per common share are net income available to common shareholders divided by the weighted average number of common shares outstanding during the period. Diluted earnings per common share include the dilutive effect of additional potential common shares issuable under stock options and warrants. Earnings and dividends per share are restated for all stock splits and dividends through the date of issue of the financial statements.

**Earnings (Loss) Allocated to Participating Securities** – Our issued and outstanding Series C Preferred Stock is automatically convertible into common stock at such time as the holder together with its affiliates beneficially own less than 9.9% of the then outstanding common shares of the company. We also have issued and outstanding unvested common shares to employees and directors through our stock incentive plan. Earnings (loss) are allocated to these participating securities based on their percentage of total issued and outstanding shares.

**Loss Contingencies** – Loss contingencies, including claims and legal actions arising in the ordinary course of business, are recorded as liabilities when the likelihood of loss is probable and an amount or range of loss can be reasonably estimated. Management does not believe there now are such matters that will have a material effect on the financial statements.

**Dividend Restriction** – Banking regulations require maintaining certain capital levels and may limit the dividends paid by the Bank to the Company or by the Company to shareholders. (See Note 17 for more specific disclosure.)

**Fair Value of Financial Instruments** – Fair values of financial instruments are estimated using relevant market information and other assumptions, as more fully disclosed in Note 19. Fair value estimates involve uncertainties and matters of significant judgment regarding interest rates, credit risk, prepayments, and other factors, especially in the absence of broad markets for particular items. Changes in assumptions or in market conditions could significantly affect the estimates.

**Reclassifications** – Some items in the prior year financial statements were reclassified to conform to the current presentation. Reclassifications had no effect on prior year net loss or shareholders' equity.

## **NOTE 2 – GOING CONCERN CONSIDERATIONS AND FUTURE PLANS**

The consolidated financial statements have been prepared on a going concern basis, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business for the foreseeable future. However, the events and circumstances described in this Note create an uncertainty about the Company's ability to continue as a going concern.

For the year ended December 31, 2012, we reported net loss to common shareholders of \$33.4 million. This loss was attributable primarily to \$40.3 million of provision for loan losses expense due to continued decline in credit trends in our portfolio that resulted in net charge-offs of \$36.1 million, OREO expense of \$10.5 million resulting from fair value write-downs driven by new appraisals and reduced marketing prices, net loss on sales, and ongoing operating expense. We also had lower net interest margin due to lower average loans outstanding, loans repricing at lower rates, and the level of non-performing loans in our portfolio. Net loss to common shareholders of \$33.4 million, for the year ended December 31, 2012, compares with net loss to common shareholders of \$105.2 million for year ended December 31, 2011.

During the year ended December 31, 2011, we recorded a net loss to common shareholders of \$105.2 million. This loss was attributable to a \$23.8 million goodwill impairment charge, the establishment of a \$31.7 million valuation allowance on our deferred tax assets, OREO expense of \$47.5 million related to valuation adjustments for our change in strategy related to certain properties, fair value write-downs related to new appraisals received for properties in the portfolio during 2011, net loss on the sale of OREO properties, and increase in carrying costs associated with carrying these higher levels of assets. We also recorded a provision for loan losses expense of \$62.6 million due to the continued decline in credit trends within our portfolio.

In June 2011, the Bank entered into a Consent Order with the FDIC and KDFI in which the Bank agreed, among other things, to improve asset quality, reduce loan concentrations, and maintain a minimum Tier 1 leverage ratio of 9% and a minimum total risk based capital ratio of 12%. The Consent Order was included in our Current Report on 8-K filed on June 30, 2011. In October 2012, the Bank entered into a new Consent Order with the FDIC and KDFI again agreeing to maintain a minimum Tier 1 leverage ratio of 9% and a minimum total risk based capital ratio of 12%. The Bank also agreed that if it should be unable to reach the required capital levels, and if directed in writing by the FDIC, then the Bank would within 30 days develop, adopt and implement a written plan to sell or merge itself into another federally insured financial institution or otherwise immediately obtain a sufficient capital investment into the Bank to fully meet the capital requirements.

We expect to continue to work with our regulators toward capital ratio compliance as outlined in the written capital plan submitted by the Bank in December 2012. The new Consent Order also requires the Bank to continue to adhere to the plans implemented in response to the June 2011 Consent Order, and includes the substantive provisions of the June 2011 Consent Order. The new Consent Order was included in our Current Report on 8-K filed on September 19, 2012. As of December 31, 2012, the capital ratios required by the Consent Order were not met.

In order to meet these capital requirements, the Board of Directors and management are continuing to evaluate strategies to achieve the following objectives:

- Increasing capital through a possible public offering or private placement of common stock to new and existing shareholders. We have engaged Sandler O'Neill & Partners, LP to act as our financial advisor and to assist our Board in this evaluation and to assist in evaluating our options for the redemption of our Series A preferred stock issued to the US Treasury in 2008 under the Capital Purchase Program.
- Continuing to operate the Company and Bank in a safe and sound manner. This strategy will require us to reduce our lending concentrations, remediate non-performing loans, and reduce other noninterest expense through the disposition of OREO.
- Continuing with succession planning and adding resources to the management team. John T. Taylor was named President and CEO for PBI Bank and appointed to the board of directors in July 2012. Additionally, John R. Davis was appointed Chief Credit Officer of PBI Bank in August 2012, with responsibility for establishing and executing the credit quality policies and overseeing credit administration for the organization.
- Evaluating our internal processes and procedures, distribution of labor, and work-flow to ensure we have adequately and appropriately deployed resources in an efficient manner in the current environment. To this end, we believe the opportunity exists for the centralization of key processes which will lead to improved execution and cost savings.
- Executing on our commitment to improve credit quality and reduce loan concentrations and balance sheet risk.
  - We have reduced the size of our loan portfolio significantly from \$1.3 billion at December 31, 2010 to \$1.1 billion at December 31, 2011, and \$899.1 million at December 31, 2012. We have significantly improved our staffing in the commercial lending area which is now led by John R. Davis, who joined the management team in August 2012 and now serves as Chief Credit Officer.
  - Our Consent Order calls for us to reduce our construction and development loans to not more than 75% of total risk-based capital. We were not in compliance at December 31, 2012 with construction and development loans representing 82% of total risk-based capital. These loans totaled \$70.3 million, or 82% of total risk-based capital, at December 31, 2012 and \$101.5 million, or 85% of total risk-based capital, at December 31, 2011.

- o Our Consent Order also requires us to reduce non-owner occupied commercial real estate loans, construction and development loans, and multi-family residential real estate loans as a group, to not more than 250% of total risk-based capital. While we have made significant improvements over the last year, we were not in compliance with this concentration limit at December 31, 2012. These loans totaled \$311.1 million, or 362% of total risk-based capital, at December 31, 2012 compared with \$414.6 million, or 349% of total risk-based capital, at December 31, 2011.
- o We are working to reduce non-owner occupied commercial real estate loans, construction and development loans, and multi-family residential real estate loans by curtailing new construction and development lending and new non-owner occupied commercial real estate lending. We are also receiving principal reductions from amortizing credits and pay-downs from our customers who sell properties built for resale. We have reduced the construction loan portfolio from \$199.5 million at December 31, 2010 to \$70.3 million at December 31, 2012. Our non-owner occupied commercial real estate loans declined from \$293.3 million at December 31, 2010 to \$189.8 million at December 31, 2012.
- Executing on our commitment to sell other real estate owned and reinvest in quality income producing assets.
  - o The remediation process for loans secured by real estate has led the Bank to acquire significant levels of OREO in 2012, 2011, and 2010. The Bank acquired \$33.5 million, \$41.9 million, and \$90.8 million of OREO during 2012, 2011, and 2010, respectively.
  - o We have incurred significant losses in disposing of OREO. We incurred losses totaling \$9.3 million, \$42.8 million, and \$13.9 million in 2012, 2011, and 2010, respectively, from sales and fair value write-downs attributable to declining valuations as evidenced by new appraisals and from changes in our sales strategies.
  - o To ensure that we maximize the value we receive upon the sale of OREO, we continue to evaluate sales opportunities and channels. We are targeting multiple sales opportunities and channels through internal marketing and the use of brokers, auctions, and technology sales platforms. Proceeds from the sale of OREO totaled \$22.5 million during 2012, \$26.0 in 2011, and \$25.0 million in 2010.
  - o At December 31, 2011, the OREO portfolio consisted of 75% construction, development, and land assets. At December 31, 2012, this concentration had declined to 51%. This is consistent with our reduction of construction, development and other land loans, which have declined to \$70.3 million at December 31, 2012, compared to \$101.5 million at December 31, 2011. Over the past year, the composition of our OREO portfolio has shifted to be more heavily weighted towards commercial real estate properties with a cash flow opportunity and 1-4 family residential properties, which we have found to be more liquid than construction, development, and land assets. Commercial real estate properties represents 35% of the OREO portfolio at December 31, 2012 compared with 15% at December 31, 2011. 1-4 family residential properties represent 12% of the OREO portfolio at December 31, 2012 compared with 7% at December 31, 2011.
- Evaluating other strategic alternatives, such as the sale of assets or branches.

Bank regulatory agencies can exercise discretion when an institution does not meet the terms of a consent order. Based on individual circumstances, the agencies may issue mandatory directives, impose monetary penalties, initiate changes in management, or take more serious adverse actions.

These financial statements do not include any adjustments that may result should the Company be unable to continue as a going concern.

### NOTE 3 – SECURITIES

The fair value of available for sale securities and the related gross unrealized gains and losses recognized in accumulated other comprehensive income (loss) were as follows:

	<u>Amortized Cost</u>	<u>Gross Unrealized Gains</u>	<u>Gross Unrealized Losses</u>	<u>Fair Value</u>
	(in thousands)			
<b>December 31, 2012</b>				
U.S. Government and federal agency	\$ 5,603	\$ 530	\$ —	\$ 6,133
Agency mortgage-backed: residential	94,298	1,141	(257)	95,182
State and municipal	52,485	2,335	(87)	54,733
Corporate bonds	18,851	1,150	(37)	19,964
Other debt securities	572	46	—	618
Total debt securities	<u>171,809</u>	<u>5,202</u>	<u>(381)</u>	<u>176,630</u>
Equity	1,359	487	—	1,846
Total	<u>\$ 173,168</u>	<u>\$ 5,689</u>	<u>\$ (381)</u>	<u>\$ 178,476</u>
<b>December 31, 2011</b>				
U.S. Government and federal agency	\$ 10,494	\$ 1,149	\$ —	\$ 11,643
Agency mortgage-backed: residential	97,286	2,211	(22)	99,475
State and municipal	35,456	2,610	(4)	38,062
Corporate bonds	7,259	315	(242)	7,332
Other debt securities	572	34	—	606
Total debt securities	<u>151,067</u>	<u>6,319</u>	<u>(268)</u>	<u>157,118</u>
Equity	1,359	356	—	1,715
Total	<u>\$ 152,426</u>	<u>\$ 6,675</u>	<u>\$ (268)</u>	<u>\$ 158,833</u>

Sales and calls of available for sale securities were as follows:

	<u>2012</u>	<u>2011</u>	<u>2010</u>
	(in thousands)		
Proceeds	\$ 93,199	\$ 50,318	\$ 96,808
Gross gains	3,543	1,108	6,079
Gross losses	307	—	927

The tax provision related to these net gains and losses realized on sales were \$1.1 million, \$388,000, and \$1.8 million, respectively.

The amortized cost and fair value of our debt securities are shown by contractual maturity. Expected maturities may differ from actual maturities if borrowers have the right to call or prepay obligations with or without call or prepayment penalties. Securities not due at a single maturity date, mortgage-backed, are shown separately.

	<u>December 31, 2012</u>	
	<u>Amortized Cost</u>	<u>Fair Value</u>
	(in thousands)	
Maturity		
Available-for-sale		
Within one year	\$ 12,656	\$ 12,713
One to five years	14,582	16,102
Five to ten years	41,119	43,112
Beyond ten years	9,154	9,521
Agency mortgage-backed: residential	94,298	95,182
Total	<u>\$ 171,809</u>	<u>\$ 176,630</u>

Securities pledged at year-end 2012 and 2011 had carrying values of approximately \$76.4 million and \$57.7 million, respectively, and were pledged to secure public deposits and repurchase agreements.

At year-end 2012 and 2011, there were no holdings of securities of any one issuer, other than the U.S. Government and its agencies, in an amount greater than 10% of stockholders' equity.



Securities with unrealized losses at year-end 2012 and 2011, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, are as follows:

Description of Securities	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
(in thousands)						
<b>2012</b>						
Agency mortgage-backed: residential	\$ 23,375	\$ (257)	\$ —	\$ —	\$ 23,375	\$ (257)
State and municipal	7,961	(87)	—	—	7,961	(87)
Corporate bonds	3,777	(37)	—	—	3,777	(37)
Equity securities	2	—	—	—	2	—
Total temporarily impaired	<u>\$ 35,115</u>	<u>\$ (381)</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 35,115</u>	<u>\$ (381)</u>
<b>2011</b>						
Agency mortgage-backed: residential	\$ 2,159	\$ (22)	\$ —	\$ —	\$ 2,159	\$ (22)
State and municipal	508	(4)	—	—	508	(4)
Corporate bonds	2,805	(242)	—	—	2,805	(242)
Total temporarily impaired	<u>\$ 5,472</u>	<u>\$ (268)</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 5,472</u>	<u>\$ (268)</u>

The Company evaluates securities for other-than-temporary impairment at least on a quarterly basis, and more frequently when economic or market concerns warrant such evaluation. Consideration is given to the length of time and the extent to which the fair value has been less than cost, the financial condition and near-term prospects of the issuer, underlying credit quality of the issuer, and the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. In analyzing an issuer's financial condition, the Company may consider whether the securities are issued by the federal government or its agencies, whether downgrades by bond rating agencies have occurred, the sector or industry trends and cycles affecting the issuer, and the results of reviews of the issuer's financial condition. In December 2011, we recorded an other-than-temporary impairment charge totaling \$41,000 for equity securities held in our portfolio with an adjusted cost basis of \$206,000. The market prices of the stocks had been below our adjusted basis for more than twelve months and after consideration of the companies financial conditions and the likelihood the market value would recover to our cost basis in a reasonable period of time, the investment was written down to fair value. As of December 31, 2012, management does not believe any securities in our portfolio with unrealized losses should be classified as other than temporarily impaired at this time. Management currently intends to hold all securities with unrealized losses until recovery, which for fixed income securities may be at maturity.

#### NOTE 4 – LOANS

Loans at year-end by class were as follows:

	2012	2011
	(in thousands)	
Commercial	\$ 52,567	\$ 71,216
Commercial Real Estate:		
Construction	70,284	101,471
Farmland	80,825	90,958
Other	322,687	423,844
Residential Real Estate:		
Multi-family	50,986	60,410
1-4 Family	278,273	337,350
Consumer	20,383	26,011
Agriculture	22,317	23,770
Other	770	993
Subtotal	<u>899,092</u>	<u>1,136,023</u>
Less: Allowance for loan losses	(56,680)	(52,579)
Loans, net	<u>\$ 842,412</u>	<u>\$ 1,083,444</u>

Activity in the allowance for loan losses for the years indicated was as follows:

	<u>2012</u>	<u>2011</u>	<u>2010</u>
	(in thousands)		
Beginning balance	\$ 52,579	\$ 34,285	\$ 26,392
Provision for loan losses	40,250	62,600	30,100
Loans charged-off	(37,515)	(44,646)	(22,461)
Loan recoveries	1,366	340	254
Ending balance	<u>\$ 56,680</u>	<u>\$ 52,579</u>	<u>\$ 34,285</u>

The following table presents the activity in the allowance for loan losses by portfolio segment for the year ended December 31, 2012:

	<u>Commercial</u>	<u>Commercial Real Estate</u>	<u>Residential Real Estate</u>	<u>Consumer</u>	<u>Agriculture</u>	<u>Other</u>	<u>Total</u>
	(in thousands)						
Beginning balance	\$ 4,207	\$ 33,024	\$ 14,217	\$ 792	\$ 325	\$ 14	\$ 52,579
Provision for loan losses	3,850	23,275	10,884	1,070	1,170	1	40,250
Loans charged off	(3,784)	(22,366)	(9,071)	(1,130)	(1,164)	-	(37,515)
Recoveries	129	835	205	125	72	-	1,366
Ending balance	<u>\$ 4,402</u>	<u>\$ 34,768</u>	<u>\$ 16,235</u>	<u>\$ 857</u>	<u>\$ 403</u>	<u>\$ 15</u>	<u>\$ 56,680</u>

The following table presents the activity in the allowance for loan losses by portfolio segment for the year ended December 31, 2011:

	<u>Commercial</u>	<u>Commercial Real Estate</u>	<u>Residential Real Estate</u>	<u>Consumer</u>	<u>Agriculture</u>	<u>Other</u>	<u>Total</u>
	(in thousands)						
Beginning balance	\$ 2,147	\$ 24,075	\$ 7,224	\$ 701	\$ 134	\$ 4	\$ 34,285
Provision for loan losses	6,188	34,043	20,253	1,074	1,032	10	62,600
Loans charged off	(4,197)	(25,243)	(13,295)	(1,070)	(841)	-	(44,646)
Recoveries	69	149	35	87	-	-	340
Ending balance	<u>\$ 4,207</u>	<u>\$ 33,024</u>	<u>\$ 14,217</u>	<u>\$ 792</u>	<u>\$ 325</u>	<u>\$ 14</u>	<u>\$ 52,579</u>

The following table presents the balance in the allowance for loan losses and the recorded investment in loans by portfolio segment and based on the impairment method as of December 31, 2012:

	<u>Commercial</u>	<u>Commercial Real Estate</u>	<u>Residential Real Estate</u>	<u>Consumer</u>	<u>Agriculture</u>	<u>Other</u>	<u>Total</u>
	(in thousands)						
<b>Allowance for loan losses:</b>							
Ending allowance balance attributable to loans:							
Individually evaluated for impairment	\$ 263	\$ 16,046	\$ 4,641	\$ 68	\$ 5	\$ 11	\$ 21,034
Collectively evaluated for impairment	4,139	18,722	11,594	789	398	4	35,646
Total ending allowance balance	<u>\$ 4,402</u>	<u>\$ 34,768</u>	<u>\$ 16,235</u>	<u>\$ 857</u>	<u>\$ 403</u>	<u>\$ 15</u>	<u>\$ 56,680</u>
<b>Loans:</b>							
Loans individually evaluated for impairment	\$ 5,296	\$ 125,922	\$ 56,799	\$ 212	\$ 55	\$ 524	\$ 188,808
Loans collectively evaluated for impairment	47,271	347,874	272,460	20,171	22,262	246	710,284
Total ending loans balance	<u>\$ 52,567</u>	<u>\$ 473,796</u>	<u>\$ 329,259</u>	<u>\$ 20,383</u>	<u>\$ 22,317</u>	<u>\$ 770</u>	<u>\$ 899,092</u>

The following table presents the balance in the allowance for loan losses and the recorded investment in loans by portfolio segment and based on the impairment method as of December 31, 2011:

	<u>Commercial</u>	<u>Commercial Real Estate</u>	<u>Residential Real Estate</u>	<u>Consumer</u>	<u>Agriculture</u>	<u>Other</u>	<u>Total</u>
	(in thousands)						
<b>Allowance for loan losses:</b>							
Ending allowance balance attributable to loans:							
Individually evaluated for impairment	\$ 554	\$ 9,580	\$ 2,172	\$ —	\$ —	\$ 8	\$ 12,314
Collectively evaluated for impairment	3,653	23,444	12,045	792	325	6	40,265
Total ending allowance balance	<u>\$ 4,207</u>	<u>\$ 33,024</u>	<u>\$ 14,217</u>	<u>\$ 792</u>	<u>\$ 325</u>	<u>\$ 14</u>	<u>\$ 52,579</u>
<b>Loans:</b>							
Loans individually evaluated for impairment	\$ 5,032	\$ 116,676	\$ 27,848	\$ —	\$ 631	\$ 540	\$ 150,727
Loans collectively evaluated for impairment	66,184	499,598	369,911	26,011	23,139	453	985,296
Total ending loans balance	<u>\$ 71,216</u>	<u>\$ 616,274</u>	<u>\$ 397,759</u>	<u>\$ 26,011</u>	<u>\$ 23,770</u>	<u>\$ 993</u>	<u>\$ 1,136,023</u>

### Impaired Loans

Impaired loans include restructured loans and commercial, construction, agriculture, and commercial real estate loans on non-accrual or classified as doubtful, whereby collection of the total amount is improbable, or loss, whereby all or a portion of the loan has been written off or a specific allowance for loss had been provided.

	<u>2012</u>	<u>2011</u>	<u>2010</u>
	(in thousands)		
Average of impaired loans during the year	\$ 175,828	\$ 95,331	\$ 69,167
Interest income recognized during impairment	3,976	2,594	1,358
Cash basis interest income recognized	355	412	115

The following table presents information related to loans individually evaluated for impairment by class of loan as of and for the year ended December 31, 2012:

	<u>Unpaid Principal Balance</u>	<u>Recorded Investment</u>	<u>Allowance For Loan Losses Allocated</u>	<u>Average Recorded Investment</u>	<u>Interest Income Recognized</u>	<u>Cash Basis Income Recognized</u>
	(in thousands)					
<b>With No Related Allowance Recorded:</b>						
Commercial	\$ 1,460	\$ 1,234	\$ —	\$ 1,637	\$ 5	\$ 4
Commercial real estate:						
Construction	1,155	1,109	—	1,745	2	2
Farmland	4,448	4,448	—	4,706	57	57
Other	2,134	1,892	—	3,436	3	3
Residential real estate:						
Multi-family	643	643	—	910	—	—
1-4 Family	13,539	13,158	—	11,291	56	56
Consumer	70	70	—	219	8	5
Agriculture	45	45	—	366	2	—
Other	—	—	—	—	—	—
<b>With An Allowance Recorded:</b>						
Commercial	4,108	4,062	263	3,964	169	27
Commercial real estate:						
Construction	26,645	25,455	1,543	19,514	348	5
Farmland	8,557	6,456	734	5,794	43	2
Other	97,699	86,562	13,769	83,087	2,011	185
Residential real estate:						
Multi-family	14,906	14,906	1,643	11,187	468	—
1-4 Family	31,021	28,092	2,998	27,404	787	9
Consumer	142	142	68	29	—	—



Agriculture	10	10	5	6	—	—
Other	524	524	11	533	17	—
Total	<u>\$ 207,106</u>	<u>\$ 188,808</u>	<u>\$ 21,034</u>	<u>\$ 175,828</u>	<u>\$ 3,976</u>	<u>\$ 355</u>

The following table presents information related to loans individually evaluated for impairment by class of loan as of and for the year ended December 31, 2011:

	<u>Unpaid Principal Balance</u>	<u>Recorded Investment</u>	<u>Allowance For Loan Losses Allocated</u> (in thousands)	<u>Average Recorded Investment</u>	<u>Interest Income Recognized</u>	<u>Cash Basis Income Recognized</u>
<b>With No Related Allowance Recorded:</b>						
Commercial	\$ 1,868	\$ 1,825	\$ —	\$ 1,984	\$ 26	\$ 26
Commercial real estate:						
Construction	1,121	1,193	—	7,584	7	5
Farmland	3,302	3,218	—	2,218	36	36
Other	6,039	5,640	—	12,114	169	99
Residential real estate:						
Multi-family	—	—	—	—	—	—
1-4 Family	—	—	—	1,351	34	—
Consumer	—	—	—	—	—	—
Agriculture	637	631	—	253	5	5
Other	—	—	—	—	—	—
<b>With An Allowance Recorded:</b>						
Commercial	3,207	3,207	554	2,630	189	90
Commercial real estate:						
Construction	23,175	20,174	4,275	6,090	143	—
Farmland	7,303	6,862	574	6,487	322	—
Other	85,535	79,859	4,731	36,583	899	148
Residential real estate:						
Multi-family	4,795	4,316	558	2,824	150	—
1-4 Family	26,225	23,262	1,614	15,105	614	3
Consumer	—	—	—	—	—	—
Agriculture	—	—	—	—	—	—
Other	540	540	8	108	—	—
Total	<u>\$ 163,747</u>	<u>\$ 150,727</u>	<u>\$ 12,314</u>	<u>\$ 95,331</u>	<u>\$ 2,594</u>	<u>\$ 412</u>

#### Troubled Debt Restructuring

A troubled debt restructuring (TDR) is where the Company has agreed to a loan modification in the form of a concession for a borrower who is experiencing financial difficulty. The majority of the Company's TDRs involve a reduction in interest rate, a deferral of principal for a stated period of time, or an interest only period. All TDRs are considered impaired and the Company has allocated reserves for these loans to reflect the present value of the concessionary terms granted to the customer.

The following table presents the types of TDR loan modifications by portfolio segment outstanding as of December 31, 2012 and 2011:

	<u>TDRs Performing to Modified Terms</u>	<u>TDRs Not Performing to Modified Terms</u> (in thousands)	<u>Total TDRs</u>
<b><u>December 31, 2012</u></b>			
Commercial			
Rate reduction	\$ 1,972	\$ —	\$ 1,972
Principal deferral	887	—	887
Interest only payments	—	958	958
Commercial Real Estate:			
Construction			
Rate reduction	4,834	4,459	9,293
Farmland			
Rate reduction	150	—	150
Principal deferral	725	2,438	3,163
Other			
Rate reduction	36,515	22,631	59,146
Principal deferral	1,195	—	1,195
Interest only payments	2,466	2,107	4,573
Residential Real Estate:			
Multi-family			
Rate reduction	13,087	—	13,087
Interest only payments	652	—	652
1-4 Family			
Rate reduction	14,323	7,871	22,194
Consumer			
Rate reduction	14	—	14
Other			
Rate reduction	524	—	524
Total TDRs	<u>\$ 77,344</u>	<u>\$ 40,464</u>	<u>\$ 117,808</u>
<b><u>December 31, 2011</u></b>			
Commercial			
Rate reduction	\$ 1,231	\$ —	\$ 1,231
Principal deferral	898	—	898
Commercial Real Estate:			
Construction			
Rate reduction	11,155	3,767	14,922
Interest only payments	—	1,404	1,404
Farmland			
Rate reduction	182	—	182
Principal deferral	746	5,101	5,847
Other			
Rate reduction	42,946	20,446	63,392
Interest only payments	1,288	—	1,288
Residential Real Estate:			
Multi-family			
Rate reduction	2,247	1,413	3,660
Interest only payments	656	—	656
1-4 Family			
Rate reduction	12,255	7,176	19,431
Principal deferral	—	247	247
Other			
Rate reduction	540	—	540
Total TDRs	<u>\$ 74,144</u>	<u>\$ 39,554</u>	<u>\$ 113,698</u>

At December 31, 2012 and 2011, 66% and 65%, respectively, of the Company's TDRs were performing according to their modified terms. The Company allocated \$15.1 million and \$10.6 million as of December 31, 2012 and 2011, respectively, in reserves to customers whose loan terms have been modified in TDRs. The Company has committed to lend additional amounts totaling \$259,000 and \$317,000 as of December 31, 2012 and 2011, respectively, to customers with outstanding loans that are classified as TDRs.



The following table presents a summary of the types of TDR loan modifications by portfolio type that occurred during the twelve months ended December 31, 2012 and 2011:

	<u>TDRs Performing to Modified Terms</u>	<u>TDRs Not Performing to Modified Terms</u> (in thousands)	<u>Total TDRs</u>
<b><u>December 31, 2012</u></b>			
Commercial			
Rate reduction	\$ 1,972	\$ —	\$ 1,972
Interest only payments	—	958	958
Commercial Real Estate:			
Construction			
Rate reduction	—	831	831
Farmland			
Rate reduction	150	—	150
Other			
Rate reduction	16,468	1,089	17,557
Principal deferral	1,194	—	1,194
Interest only payments	2,466	2,107	4,573
Residential Real Estate:			
Multi-family			
Rate reduction	12,805	—	12,805
1-4 Family			
Rate reduction	7,514	—	7,514
Consumer			
Rate reduction	14	—	14
Total TDRs	<u>\$ 42,583</u>	<u>\$ 4,985</u>	<u>\$ 47,568</u>
<b><u>December 31, 2011</u></b>			
Commercial			
Rate reduction	\$ 1,231	\$ —	\$ 1,231
Commercial Real Estate:			
Construction			
Rate reduction	11,155	3,367	14,522
Interest only payments	—	1,404	1,404
Farmland			
Rate reduction	182	—	182
Principal deferral	746	—	746
Other			
Rate reduction	41,682	20,446	62,128
Residential Real Estate:			
Multi-family			
Rate reduction	2,247	—	2,247
Interest only payments	656	—	656
1-4 Family			
Rate reduction	7,968	1,651	9,619
Principal deferral	—	247	247
Other			
Rate reduction	540	—	540
Total TDRs	<u>\$ 66,407</u>	<u>\$ 27,115</u>	<u>\$ 93,522</u>

As of December 31, 2012 and 2011, 90% and 71%, respectively, of the Company's TDRs that occurred during 2012 and 2011, respectively, were performing in accordance with their modified terms. The Company has allocated \$4.8 million and \$3.8 million, respectively, in reserves to customers whose loan terms have been modified during 2012 and 2011, respectively. For modifications occurring during the twelve months ended December 31, 2012 and 2011, the post-modification balances approximate the pre-modification balances.

During 2012 and 2011, approximately \$12.0 million and \$33.2 million of TDRs, respectively, defaulted on their restructured loan and the default occurred within the 12 month period following the loan modification. These defaults consisted of \$6.6 million in commercial real estate loans, \$3.2 million in construction loans, \$1.2 million in 1-4 family residential real estate loans, and \$958,000 in commercial loans. A default is considered to have occurred once the TDR is past due 90 days or more or it has been placed on nonaccrual.



## Nonperforming Loans

Nonperforming loans include impaired loans and smaller balance homogeneous loans, such as residential mortgage and consumer loans, that are collectively evaluated for impairment.

The following table presents the recorded investment in nonaccrual and loans past due 90 days and still on accrual by class of loan as of December 31, 2012 and 2011:

	Nonaccrual		Loans Past Due 90 Days And Over Still Accruing	
	2012	2011	2012	2011
	(in thousands)			
Commercial	\$ 2,437	\$ 2,903	\$ 36	\$ 109
Commercial Real Estate:				
Construction	7,808	13,564	—	—
Farmland	10,030	9,152	—	26
Other	46,036	35,154	—	918
Residential Real Estate:				
Multi-family	1,516	2,921	—	—
1-4 Family	26,501	27,375	50	265
Consumer	135	320	—	—
Agriculture	54	631	—	32
Other	—	—	—	—
Total	<u>\$ 94,517</u>	<u>\$ 92,020</u>	<u>\$ 86</u>	<u>\$ 1,350</u>

Subsequent to December 31, 2012, loans to two significant borrowing relationships included in the following table of past due loans, which were past due 30-59 days totaling \$23.5 million and loans past due 60-89 days totaling \$12.7 million, were placed on non-accrual. These loans were classified as impaired at December 31, 2012.

The following table presents the aging of the recorded investment in past due loans by class as of December 31, 2012 and 2011:

	30 – 59 Days Past Due	60 – 89 Days Past Due	90 Days And Over Past Due	Non-accrual	Total Past Due And Non-accrual
	(in thousands)				
<b>December 31, 2012</b>					
Commercial	\$ 1,279	\$ 90	\$ 36	\$ 2,437	\$ 3,842
Commercial Real Estate:					
Construction	10,510	5,815	—	7,808	24,133
Farmland	922	58	—	10,030	11,010
Other	5,138	13,037	—	46,036	64,211
Residential Real Estate:					
Multi-family	8,762	—	—	1,516	10,278
1-4 Family	11,145	1,221	50	26,501	38,917
Consumer	310	75	—	135	520
Agriculture	153	7	—	54	214
Other	—	—	—	—	—
Total	<u>\$ 38,219</u>	<u>\$ 20,303</u>	<u>\$ 86</u>	<u>\$ 94,517</u>	<u>\$ 153,125</u>

	<u>30 – 59 Days Past Due</u>	<u>60 – 89 Days Past Due</u>	<u>90 Days And Over Past Due</u>	<u>Non-accrual</u>	<u>Total Past Due And Non-accrual</u>
(in thousands)					
<b>December 31, 2011</b>					
Commercial	\$ 2,792	\$ 91	\$ 109	\$ 2,903	\$ 5,895
Commercial Real Estate:					
Construction	20	—	—	13,564	13,584
Farmland	1,353	305	26	9,152	10,836
Other	4,555	756	918	35,154	41,383
Residential Real Estate:					
Multi-family	442	135	—	2,921	3,498
1-4 Family	7,568	2,511	265	27,375	37,719
Consumer	593	149	—	320	1,062
Agriculture	23	—	32	631	686
Other	—	—	—	—	—
Total	<u>\$ 17,346</u>	<u>\$ 3,947</u>	<u>\$ 1,350</u>	<u>\$ 92,020</u>	<u>\$ 114,663</u>

**Credit Quality Indicators** – We categorize loans into risk categories at origination based upon original underwriting. Subsequent to origination, we categorized loans into risk categories based on relevant information about the ability of borrowers to service their debt such as current financial information, historical payment experience, credit documentation, public information, and current economic trends, among other factors. Loans are analyzed individually by classifying the loans as to credit risk. This analysis includes loans with an outstanding balance greater than \$500,000 and non-homogeneous loans, such as commercial and commercial real estate loans. This analysis is performed on a quarterly basis. We do not have any non-rated loans. The following definitions are used for risk ratings:

**Watch** – Loans classified as watch are those loans which have experienced a potentially adverse development which necessitates increased monitoring.

**Special Mention** – Loans classified as special mention do not have all of the characteristics of substandard or doubtful loans. They have one or more deficiencies which warrant special attention and which corrective action, such as accelerated collection practices, may remedy.

**Substandard** – Loans classified as substandard are those loans with clear and defined weaknesses such as a highly leveraged position, unfavorable financial ratios, uncertain repayment sources or poor financial condition which may jeopardize the repayment of the debt as contractually agreed. They are characterized by the distinct possibility that we will sustain some losses if the deficiencies are not corrected.

**Doubtful** – Loans classified as doubtful are those loans which have characteristics similar to substandard loans but with an increased risk that collection or liquidation in full is highly questionable and improbable.

Loans not meeting the criteria above that are analyzed individually as part of the above described process are considered to be “Pass” rated loans. As of December 31, 2012 and 2011, and based on the most recent analysis performed, the risk category of loans by class of loans is as follows:

	<u>Pass</u>	<u>Watch</u>	<u>Special Mention</u>	<u>Substandard</u>	<u>Doubtful</u>	<u>Total</u>
(in thousands)						
<b>December 31, 2012</b>						
Commercial	\$ 27,085	\$ 10,153	\$ 6,495	\$ 8,772	\$ 62	\$ 52,567
Commercial Real Estate:						
Construction	26,085	21,713	3,647	18,839	—	70,284
Farmland	47,017	13,461	3,532	16,815	—	80,825
Other	122,603	66,223	14,955	118,635	271	322,687
Residential Real Estate:						
Multi-family	18,387	14,637	—	17,962	—	50,986
1-4 Family	159,975	47,030	5,167	66,101	—	278,273
Consumer	17,232	2,211	35	842	63	20,383
Agriculture	19,256	1,467	869	725	—	22,317
Other	246	524	—	—	—	770
Total	<u>\$ 437,886</u>	<u>\$ 177,419</u>	<u>\$ 34,700</u>	<u>\$ 248,691</u>	<u>\$ 396</u>	<u>\$ 899,092</u>





	<u>Pass</u>	<u>Watch</u>	<u>Special Mention</u>	<u>Substandard</u>	<u>Doubtful</u>	<u>Total</u>
	(in thousands)					
<b>December 31, 2011</b>						
Commercial	\$ 53,223	\$ 9,357	\$ 3,237	\$ 5,300	\$ 99	\$ 71,216
Commercial Real Estate:						
Construction	45,407	13,132	7,777	35,155	—	101,471
Farmland	69,880	4,955	2,688	13,236	199	90,958
Other	213,406	80,149	30,787	99,502	—	423,844
Residential Real Estate:						
Multi-family	37,807	4,619	2,100	15,884	—	60,410
1-4 Family	247,423	28,734	2,276	58,891	26	337,350
Consumer	23,721	1,418	43	762	67	26,011
Agriculture	22,502	343	14	911	—	23,770
Other	453	540	—	—	—	993
Total	<u>\$ 713,822</u>	<u>\$ 143,247</u>	<u>\$ 48,922</u>	<u>\$ 229,641</u>	<u>\$ 391</u>	<u>\$ 1,136,023</u>

#### NOTE 5 – PREMISES AND EQUIPMENT

Year-end premises and equipment were as follows:

	<u>2012</u>	<u>2011</u>
	(in thousands)	
Land and buildings	\$ 24,860	\$ 23,493
Furniture and equipment	18,074	19,086
	42,934	42,579
Accumulated depreciation	(22,129)	(21,038)
	<u>\$ 20,805</u>	<u>\$ 21,541</u>

Depreciation expense was \$1,165,000, \$1,205,000 and \$1,450,000 for 2012, 2011 and 2010, respectively.

#### NOTE 6 – OTHER REAL ESTATE OWNED

Other real estate owned (OREO) is real estate acquired as a result of foreclosure or by deed in lieu of foreclosure. It is classified as real estate owned until such time as it is sold. When property is acquired as a result of foreclosure or by deed in lieu of foreclosure, it is recorded at its fair market value less cost to sell. Any write-down of the property at the time of acquisition is charged to the allowance for loan losses. Subsequent reductions in fair value are recorded as non-interest expense. To determine the fair value of OREO for smaller dollar single family homes, we consult with internal real estate sales staff and external realtors, investors, and appraisers. If the internally evaluated market price is below our underlying investment in the property, appropriate write-downs are taken.

For larger dollar residential and commercial real estate properties, we obtain a new appraisal of the subject property in connection with the transfer to other real estate owned. We obtain updated appraisals each year on the anniversary date of ownership unless a sale is imminent.

We continue to explore opportunities to sell OREO properties in bulk. In 2011, as a result of adopting a strategy to more aggressively market our OREO properties, we determined that we would be willing to sell certain OREO properties at an amount below their individual appraised values. Accordingly, we adjusted our valuations for these properties downward by increasing their valuation allowances to reflect our more aggressive disposition strategy. These properties are primarily single and multi-family residential land development properties. The following table presents the major categories of OREO at the period-ends indicated:

	<u>2012</u>	<u>2011</u>
	(in thousands)	
Commercial Real Estate:		
Construction	\$ 22,912	\$ 32,538
Farmland	618	744
Other	15,577	6,620
Residential Real Estate:		
Multi-family	200	—
1-4 Family	5,518	3,214
	44,825	43,116
Valuation allowance	(1,154)	(1,667)
	<u>\$ 43,671</u>	<u>\$ 41,449</u>



	<u>2012</u>	<u>2011</u>
	(in thousands)	
<b><u>OREO Valuation Allowance Activity:</u></b>		
Beginning balance	\$ 1,667	\$ 700
Provision to allowance	7,154	34,874
Write-downs	(7,667)	(33,907)
Ending balance	<u>\$ 1,154</u>	<u>\$ 1,667</u>

Activity relating to other real estate owned during the years indicated is as follows:

	<u>2012</u>	<u>2011</u>
	(in thousands)	
<b><u>OREO Activity</u></b>		
OREO as of January 1	\$ 43,116	\$ 68,335
Real estate acquired	33,528	41,917
Valuation adjustments for sales strategy change	—	(25,613)
Valuation adjustments for declining market values	(7,667)	(8,294)
Improvements	1	1,650
Loss on sale	(1,672)	(8,889)
Proceeds from sale of properties	(22,481)	(25,990)
OREO as of December 31	<u>\$ 44,825</u>	<u>\$ 43,116</u>

Expenses related to other real estate owned include:

	<u>2012</u>	<u>2011</u>	<u>2010</u>
	(in thousands)		
Net loss on sales	\$ 1,672	\$ 8,889	\$ 565
Provision to allowance	7,154	34,874	14,062
Operating expense	1,723	3,762	1,627
Total	<u>\$ 10,549</u>	<u>\$ 47,525</u>	<u>\$ 16,254</u>

## NOTE 7 – GOODWILL AND INTANGIBLE ASSETS

### Goodwill

The change in balance of goodwill during the years indicated was as follows:

	<u>2012</u>	<u>2011</u>
	(in thousands)	
Beginning of year	\$ —	\$ 23,794
Acquired goodwill	—	—
Impairment	—	(23,794)
End of year	<u>\$ —</u>	<u>\$ —</u>

The Company evaluated goodwill for impairment annually in the fourth quarter unless events or changes in circumstances indicate potential impairment may have occurred between annual assessments. Goodwill was reviewed for impairment during the second quarter of 2011 because our common stock, which trades publicly on the NASDAQ, experienced a significant drop in value throughout the months of May and June 2011. Our stock trended downward during the first quarter of 2011 and continued downward throughout the months of May and June 2011. The stock closed on June 30, 2011 at \$4.98 per share and has traded at a market price less than book value per common share since the second quarter of 2010.

We evaluated the potential negative impact on the value of our common stock from being removed from the Russell 3000 Index during June 2011, the trend of lower earnings in 2011 compared to historical performance due to the continuing impact on earnings from loan loss provisions, non-performing loans, and foreclosed properties, and recent regulatory agreements entered into by the company. Our goodwill impairment testing completed during the fourth quarter of 2010 included, among other things, future projections of earnings at levels exceeding actual results for 2011. The level of loan loss provisions and the cost of foreclosed properties continue to exceed our prior expectations as we work through issues with our non-performing loan levels and other real estate owned portfolio.

The fair value was determined utilizing our market capitalization based upon recent common stock price levels. We also considered market comparison transactions and control premiums for institutions of a similar size and performance. Based on this analysis, we determined that our Goodwill was impaired and recorded an impairment charge of \$23.8 million in the quarter ended June 30, 2011. The impairment charge had no impact on the Company's liquidity, cash flows, or regulatory ratios.

### Acquired Intangible Assets

Acquired intangible assets were as follows as of year-end:

	2012		2011	
	<u>Gross Carrying Amount</u>	<u>Accumulated Amortization</u>	<u>Gross Carrying Amount</u>	<u>Accumulated Amortization</u>
	(in thousands)			
Amortized intangible assets:				
Core deposit intangibles	\$ 4,183	\$ 2,581	\$ 4,183	\$ 2,124
Trust account intangibles	100	53	100	43

Aggregate amortization expense was \$467,000, \$468,000 and \$464,000 for 2012, 2011 and 2010, respectively.

Estimated aggregate amortization expense for intangible assets for each of the next five years is as follows (in thousands):

2013	\$ 437
2014	407
2015	345
2016	344
2017	117

### NOTE 8 – DEPOSITS

The following table shows deposits by category:

	<u>December 31, 2012</u>	<u>December 31, 2011</u>
	(in thousands)	
Non-interest bearing	\$ 114,310	\$ 111,118
Interest checking	87,234	87,653
Money market	63,715	64,302
Savings	39,227	36,357
Certificates of deposit	760,573	1,024,333
Total	<u>\$ 1,065,059</u>	<u>\$ 1,323,763</u>

Time deposits of \$100,000 or more were approximately \$319,527,000 and \$493,344,000 at year-end 2012 and 2011, respectively.

Scheduled maturities of total time deposits for each of the next five years are as follows (in thousands):

	<u>Retail</u>	<u>Brokered</u>	<u>Total</u>
2013	\$ 394,593	\$ 15,000	\$ 409,593
2014	173,311	—	173,311
2015	152,716	—	152,716
2016	13,974	—	13,974
2017	10,894	—	10,894
Thereafter	85	—	85
	<u>\$ 745,573</u>	<u>\$ 15,000</u>	<u>\$ 760,573</u>

Historically, the Bank has utilized brokered and wholesale deposits to supplement its funding strategy. At December 31, 2012, and 2011, these deposits totaled \$15.0 million and \$118.4 million, respectively. As stipulated in the Consent Order, PBI Bank is currently restricted from accepting, renewing, or rolling-over brokered deposits without the prior receipt of a waiver on a case-by-case basis from our regulators.



## NOTE 9 – SECURITIES SOLD UNDER AGREEMENTS TO REPURCHASE

Securities sold under agreements to repurchase are financing arrangements that mature within two years. At maturity, the securities underlying the agreements are returned to the Company. Securities sold under agreements to repurchase are secured by agency, mortgage-backed, and municipal securities. Information concerning securities sold under agreements to repurchase is summarized as follows:

	<u>2012</u>	<u>2011</u>
	<u>(in thousands)</u>	
Balance at year-end	\$ 2,634	\$ 1,738
Average daily balance during the year	\$ 2,088	\$ 10,451
Average interest rate during the year	0.35%	4.20%
Maximum month-end balance during the year	\$ 2,634	\$ 11,672
Weighted average interest rate at year-end	0.23%	2.26%
Fair value of securities sold under agreements to repurchase at year-end	\$ 2,634	\$ 1,738

During 2011, we retired a \$10 million repurchase agreement prior to maturity and incurred a prepayment penalty of \$312,000.

## NOTE 10 – ADVANCES FROM FEDERAL HOME LOAN BANK

At year-end, advances from the Federal Home Loan Bank were as follows:

	<u>2012</u>	<u>2011</u>
	<u>(in thousands)</u>	
Monthly amortizing advances with fixed rates from 0.00% to 5.25% and maturities ranging from 2013 through 2033, averaging 3.21% for 2012	\$ 5,604	\$ 7,116
Total	<u>\$ 5,604</u>	<u>\$ 7,116</u>

Each advance is payable per terms on agreement, with a prepayment penalty. During 2011, we incurred prepayment penalties of \$174,000 on the prepayments of advances totaling \$5.5 million. No similar penalty was incurred during 2012. The advances were collateralized by approximately \$163.3 million and \$411.5 million of first mortgage loans, under a blanket lien arrangement at year-end 2012 and 2011, respectively. Our borrowing capacity is based on the market value of the underlying pledged loans rather than the unpaid principal balance of the pledged loans. The availability of our borrowing capacity could be affected by our financial position and the FHLB could require additional collateral or, among other things, exercise its rights to deny a funding request, at its discretion. Additionally, any new advances are limited to a one year maturity or less. At December 31, 2012, our additional borrowing capacity with the FHLB was \$23.0 million.

Scheduled principal payments on the above during the next five years (in thousands):

	<u>Advances</u>
2013	\$ 1,125
2014	729
2015	669
2016	634
2017	550
Thereafter	1,897
	<u>\$ 5,604</u>

At year-end 2012, the Company had approximately \$5.0 million of federal funds lines of credit available from correspondent institutions; however, the availability of these lines could be affected by our financial position.

## NOTE 11 – SUBORDINATED CAPITAL NOTE

The subordinated capital note issued by PBI Bank totaled \$7.0 million at December 31, 2012. The note is unsecured, bears interest at the BBA three-month LIBOR floating rate plus 300 basis points, and qualifies as Tier 2 capital. Interest only was due quarterly through September 30, 2010, at which time quarterly principal payments of \$225,000 plus interest commenced. Scheduled principal payments of \$900,000 per year are due each of the next five years with \$2,475,000 due thereafter. The note matures July 1, 2020. At December 31, 2012, the interest rate on this note was 3.36%.

## NOTE 12 – JUNIOR SUBORDINATED DEBENTURES

The junior subordinated debentures are redeemable at par prior to the maturity dates of February 13, 2034, April 15, 2034, and March 1, 2037, at the option of the Company as defined within the trust indenture. The Company has the option to defer interest payments on the junior subordinated debentures from time to time for a period not to exceed twenty (20) consecutive quarters. If payments are deferred, the Company is prohibited from paying dividends to its common stockholders. Effective with the fourth quarter of 2011, we began deferring interest payments on the junior subordinated notes which resulted in a deferral of distributions on our trust preferred securities. Therefore, future cash dividends on our common stock are subject to the prior payment of all deferred distributions on our trust preferred securities. Dividends accrued and unpaid on our junior subordinated debentures totaled \$871,000 at December 31, 2012. A summary of the junior subordinated debentures is as follows:

<u>Description</u>	<u>Issuance Date</u>	<u>Optional Prepayment Date (2)</u>	<u>Interest Rate (1)</u>	<u>Junior Subordinated Debt Owed to Trust</u>	<u>Maturity Date</u>
Porter Statutory Trust II	02-13-2004	03-17-2009	3-month LIBOR + 2.85%	\$ 5,000,000	02-13-2034
Porter Statutory Trust III	04-15-2004	06-17-2009	3-month LIBOR + 2.79%	3,000,000	04-15-2034
Porter Statutory Trust IV	12-14-2006	03-01-2012	3-month LIBOR + 1.67%	14,000,000	03-01-2037
Asencia Statutory Trust I	02-13-2004	03-17-2009	3-month LIBOR + 2.85%	3,000,000	02-13-2034
				<u>\$ 25,000,000</u>	

(1) As of December 31, 2012 the 3-month LIBOR was 0.31%.

(2) The debentures are callable on or after the optional prepayment date at their principal amount plus accrued interest.

## NOTE 13 – OTHER BENEFIT PLANS

**401(K) Plan** – The Company 401(k) Savings Plan allows employees to contribute up to 15% of their compensation, which is matched equal to 50% of the first 4% of compensation contributed. The Company, at its discretion, may make an additional contribution. Total contributions made by the Company to the plan amounted to approximately \$148,000, \$131,000 and \$188,000 in 2012, 2011 and 2010, respectively.

**Supplemental Executive Retirement Plan** – During 2004, the Company created a supplemental executive retirement plan covering certain executive officers. Under the plan, the Company pays each participant, or their beneficiary, a specific defined benefit amount over 10 years, beginning with the individual's retirement or early termination of service for reasons other than cause. A liability is accrued for the obligation under these plans. The expense incurred for the plan was \$151,000, \$49,000 and \$264,000 for the years ended December 31, 2012, 2011 and 2010, respectively. The related liability was \$1,338,000, \$1,208,000 and \$1,161,000 at December 31, 2012, 2011 and 2010, respectively, and is included in other liabilities on the balance sheets.

The Company purchased life insurance on the participants to fund the benefits of these plans. The cash surrender value of all insurance policies was \$8,398,000 and \$8,106,000 at December 31, 2012 and 2011, respectively. Income earned from the cash surrender value of life insurance totaled \$292,000, \$301,000 and \$296,000 for the years ended December 31, 2012, 2011 and 2010, respectively. The income is recorded as other non-interest income.

## NOTE 14 – INCOME TAXES

Income tax expense (benefit) was as follows:

	<u>2012</u>	<u>2011</u>	<u>2010</u>
		<u>(in thousands)</u>	
Current	\$ (65)	\$ (12,093)	\$ 4,852
Deferred	754	(17,403)	(7,898)
Net operating loss	(12,581)	(2,439)	—
Establishment of valuation allowance	—	31,717	—
Change in valuation allowance	11,827	—	—
	<u>\$ (65)</u>	<u>\$ (218)</u>	<u>\$ (3,046)</u>



Effective tax rates differ from federal statutory rate of 35% applied to income (loss) before income taxes due to the following.

	<u>2012</u>	<u>2011</u>	<u>2010</u>
	(in thousands)		
Federal statutory rate times financial statement income (loss)	\$ (11,549)	\$ (37,634)	\$ (2,600)
Effect of:			
Establishment of valuation allowance	—	31,717	—
Change in valuation allowance	11,827	—	—
Goodwill impairment charge	—	6,169	—
Tax-exempt income	(314)	(392)	(302)
Nontaxable life insurance income	(102)	(105)	(104)
Federal tax credits	—	(45)	(45)
Other, net	73	72	5
Total	<u>\$ (65)</u>	<u>\$ (218)</u>	<u>\$ (3,046)</u>

Year-end deferred tax assets and liabilities were due to the following.

	<u>2012</u>	<u>2011</u>
	(in thousands)	
Deferred tax assets:		
Allowance for loan losses	\$ 19,838	\$ 18,403
Other real estate owned write-down	10,408	12,905
Net operating loss carry-forward	15,051	2,470
New market tax credit carry-forward	208	208
Alternative minimum tax credit carry-forward	692	685
Net assets from acquisitions	592	543
Other than temporary impairment on securities	374	374
Amortization of non-compete agreements	19	27
Other	936	827
	<u>48,118</u>	<u>36,442</u>
Deferred tax liabilities:		
Fixed assets	409	445
Net unrealized gain on securities available for sale	1,858	2,242
FHLB stock dividends	1,276	1,276
Originated mortgage servicing rights	98	103
Other	549	659
	<u>4,190</u>	<u>4,725</u>
Net deferred tax asset before valuation allowance	<u>43,928</u>	<u>31,717</u>
Valuation allowance	<u>(43,928)</u>	<u>(31,717)</u>
Net deferred tax asset	<u>\$ —</u>	<u>\$ —</u>

Our estimate of the realizability of the deferred tax asset is dependent on our estimate of projected future levels of taxable income as all carryback ability was fully absorbed by our tax loss of \$40.1 million for 2011. In analyzing future taxable income levels, we considered all evidence currently available, both positive and negative. Based on our analysis, we established a valuation allowance for all deferred tax assets as of December 31, 2011.

The Company does not have any beginning and ending unrecognized tax benefits. The Company does not expect the total amount of unrecognized tax benefits to significantly increase or decrease in the next twelve months. There were no interest and penalties recorded in the income statement or accrued for the year ended December 31, 2012 related to unrecognized tax benefits.

The Company and its subsidiaries are subject to U.S. federal income tax and the Company is subject to income tax in the state of Kentucky. The Company is no longer subject to examination by taxing authorities for years before 2009.

## NOTE 15 – RELATED PARTY TRANSACTIONS

Loans to principal officers, directors, and their affiliates in 2012 were as follows (in thousands):

Beginning balance	\$ 1,376
New loans	30
Repayments	(173)
Ending balance	<u>\$ 1,233</u>

Deposits from principal officers, directors, and their affiliates at year-end 2012 and 2011 were \$1.4 million and \$2.5 million, respectively.

Our loan participation totals include participations in real estate loans purchased from and sold to two affiliate banks, The Peoples Bank, Mt. Washington and The Peoples Bank, Taylorsville. Our chairman emeritus, J. Chester Porter and his brother and our director, William G. Porter, each own a 50% interest in Lake Valley Bancorp, Inc., the parent holding company of The Peoples Bank, Taylorsville, Kentucky. J. Chester Porter, William G. Porter and our chairman and chief executive officer, Maria L. Bouvette, serve as directors of The Peoples Bank, Taylorsville. Our chairman emeritus, J. Chester Porter owns an interest of approximately 36.0% and his brother and our director, William G. Porter, owns an interest of approximately 3.0% in Crossroads Bancorp, Inc., the parent holding company of The Peoples Bank, Mount Washington, Kentucky. J. Chester Porter and Maria L. Bouvette, serve as directors of The Peoples Bank, Mount Washington. We have entered into management services agreements with each of these banks. Each agreement provides that our executives and employees provide management and accounting services to the subject bank, including overall responsibility for establishing and implementing policy and strategic planning. Maria Bouvette also serves as chief financial officer of each of the banks. We received a \$4,000 monthly fee from The Peoples Bank, Taylorsville and a \$2,000 monthly fee from The Peoples Bank, Mount Washington for these services. Beginning in 2013, these management services agreements were not renewed.

As of December 31, 2012, we had \$2.7 million of participations in real estate loans purchased from, and \$6.5 million of participations in real estate loans sold, to these affiliate banks. As of December 31, 2011, we had \$4.1 million of participations in real estate loans purchased from, and \$13.2 million of participations in real estate loans sold to, these affiliate banks. At December 31, 2012, \$1.4 million of loan participations sold to Peoples Bank, Taylorsville, and \$943,000 sold to Peoples Bank, Mt. Washington were on non-accrual.

## NOTE 16 – PREFERRED STOCK AND STOCK PURCHASE WARRANTS

In 2010, we completed a \$32 million private placement to accredited investors. Following completion of the transactions involved, Porter Bancorp had issued (i) 2,465,569 shares of common stock, (ii) 317,042 shares of Series C Preferred Stock and (iii) warrants to purchase 1,163,045 shares of non-voting common stock at a price of \$11.50 per share.

The Series C Preferred Stock has no voting rights (except when required by law), has a liquidation preference over our common stock, dividend rights equivalent to our common stock. Each share of Series C Preferred Stock automatically converts into 1.05 shares of common stock at such time as, after giving effect to the automatic conversion, the holder of such Series C Preferred Stock (together with its affiliates and any other persons with which it is acting in concert or whose holdings would otherwise be required to be aggregated for purposes of federal banking law) beneficially holds, directly or indirectly, less than 9.9% of the number of shares of common stock then issued and outstanding.

The warrants are exercisable into non-voting common stock until they expire on September 16, 2015. The non-voting common stock has no voting rights (except when required by law), but otherwise has substantially the same rights as our common stock. Upon issuance, each share of non-voting common stock automatically converts into 1.05 shares of common stock at such time as, after giving effect to the automatic conversion, the holder of non-voting common stock (together with its affiliates and any other persons with which it is acting in concert or whose holdings would otherwise be required to be aggregated for purposes of federal banking law) holds, directly or indirectly, beneficially less than 9.9% of the number of shares of common stock then issued and outstanding.

On November 21, 2008, we issued to the U.S. Treasury, in exchange for aggregate consideration of \$35.0 million, 35,000 shares of our Series A Preferred Stock and a warrant to purchase up to 330,561 shares of our common stock for \$15.88 per share. The warrant is immediately exercisable and has a 10-year term. The Series A Preferred Stock qualifies as Tier 1 capital and pays cumulative cash dividends quarterly at an annual rate of 5% for the first five years, and 9% thereafter. The Series A Preferred Stock is non-voting (except when required by law) and, beginning on February 15, 2012, may be redeemed by the Company at \$1,000 per share plus accrued unpaid dividends.

In the fourth quarter of 2011, we began deferring the payment of regular quarterly cash dividends on our Series A Preferred Stock issued to the U.S. Treasury. If we defer dividend payments for six quarters, the holder of our Series A Preferred Stock (currently the U.S. Treasury) would then have the right to appoint representatives to our Board of Directors. We will continue to accrue any deferred dividends, which will be deducted from income to common shareholders for financial statement purposes. Dividends accrued and unpaid on our Series A Preferred Stock, and interest accrued and unpaid on those dividends, totaled \$2.5 million at December 31, 2012.

## NOTE 17 – CAPITAL REQUIREMENTS AND RESTRICTIONS ON RETAINED EARNINGS

Banks and bank holding companies are subject to regulatory capital requirements administered by federal banking agencies. Capital adequacy guidelines and, additionally for banks, prompt corrective action regulations involve quantitative measures of assets, liabilities, and certain off-balance-sheet items calculated under regulatory accounting practices. Capital amounts and classifications are also subject to qualitative judgments by regulators. Failure to meet capital requirements can initiate regulatory action.

On June 24, 2011, PBI Bank entered into a Consent Order with the FDIC and the Kentucky Department of Financial Institutions. The consent order requires the Bank to complete a management study, to maintain Tier 1 capital as a percentage of total assets of at least 9% and a total risk based capital ratio of at least 12%, to develop a plan to reduce our risk position in each substandard asset in excess of \$1 million, to complete board review of the adequacy of the allowance for loan losses prior to quarterly Call Report submissions, to adopt procedures which strengthen the loan review function and ensure timely and accurate grading of credit relationships, to charge-off all assets classified as loss, to develop a plan to reduce concentrations of construction and development loans to not more than 75% of total risk based capital and non-owner occupied commercial real estate loans to not more than 250% of total risk based capital, to limit asset growth to no more than 5% in any quarter or 10% annually, to not extend additional credit to any borrower classified substandard unless the board of directors adopts prior to the extension a detailed statement giving reasons why the extension is in the best interest of the bank, and to not declare or pay any dividend without the prior consent of our regulators. We are also restricted from accepting, renewing, or rolling-over brokered deposits without the prior receipt of a waiver on a case-by-case basis from our regulators.

On September 21, 2011, we entered into a Written Agreement with the Federal Reserve Bank of St. Louis. Pursuant to the Agreement, we made formal commitments to use our financial and management resources to serve as a source of strength for the Bank and to assist the Bank in addressing weaknesses identified by the FDIC and the KDFI, to pay no dividends without prior written approval, to pay no interest or principal on subordinated debentures or trust preferred securities without prior written approval, and to submit an acceptable plan to maintain sufficient capital.

In October 2012, the Bank entered into a new Consent Order with the FDIC and KDFI again agreeing to maintain a minimum Tier 1 leverage ratio of 9% and a minimum total risk based capital ratio of 12%. The Bank cannot be considered well-capitalized while under the Consent Order. The Bank also agreed that if it should be unable to reach the required capital levels, and if directed in writing by the FDIC, then the Bank would within 30 days develop, adopt and implement a written plan to sell or merge itself into another federally insured financial institution or otherwise immediately obtain a sufficient capital investment into the Bank to fully meet the capital requirements.

The new Consent Order also requires the Bank to continue to adhere to the plans implemented in response to the June 2011 Consent Order, and includes the substantive provisions of the June 2011 Consent Order. As of December 31, 2012, the capital ratios required by the Consent Order were not met.

The following table shows the ratios of Tier 1 capital and total capital to risk-adjusted assets and the leverage ratios for Porter Bancorp, Inc. and PBI Bank at the dates indicated:

	<u>Regulatory Minimums</u>	<u>Well- Capitalized Minimums</u>	<u>Minimum Capital Ratios Under Consent Order</u>	<u>December 31, 2012</u>		<u>December 31, 2011</u>	
				<u>Porter Bancorp</u>	<u>PBI Bank</u>	<u>Porter Bancorp</u>	<u>PBI Bank</u>
Tier 1 Capital	4.0%	6.0%	N/A	6.46%	7.71%	9.23%	8.86%
Total risk-based capital	8.0	10.0	12.0%	9.81	9.82	11.22	10.86
Tier 1 leverage ratio	4.0	5.0	9.0	4.50	5.37	6.53	6.23

At December 31, 2012, PBI Bank's Tier 1 leverage ratio declined to 5.37% which is below the 9% minimum capital ratio required by the Consent Order and its total risk-based capital ratio declined to 9.82% which is below the 12% minimum capital ratio required by the Consent Order. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a materially adverse effect on our financial condition.

Kentucky banking laws limit the amount of dividends that may be paid to a holding company by its subsidiary banks without prior approval. These laws limit the amount of dividends that may be paid in any calendar year to current year's net income, as defined in the laws, combined with the retained net income of the preceding two years, less any dividends declared during those periods. PBI Bank has agreed with its primary regulators to obtain their written consent prior to declaring or paying any future dividends. As a practical matter, PBI Bank cannot pay dividends for the foreseeable future.

#### NOTE 18 – LOAN COMMITMENTS AND OTHER RELATED ACTIVITIES

Some financial instruments, such as loan commitments, lines of credit and letters of credit are issued to meet customer-financing needs. These are agreements to provide credit or to support the credit of others, as long as conditions established in the contract are met, and usually have expiration dates. Commitments may expire without being used. Off-balance-sheet risk to credit loss exists up to the face amount of these instruments, although material losses are not anticipated. The same credit policies are used to make such commitments as are used for loans, including obtaining collateral at exercise of the commitment.

The Company holds instruments, in the normal course of business, with clients that are considered financial guarantees. Standby letters of credit guarantees are issued in connection with agreements made by clients to counterparties. Standby letters of credit are contingent upon failure of the client to perform the terms of the underlying contract. The Company evaluates each credit request of its customers in accordance with established lending policies. Based on these evaluations and the underlying policies, the amount of required collateral (if any) is established. Collateral held varies but may include negotiable instruments, accounts receivable, inventory, property, plant and equipment, income producing properties, residential real estate, and vehicles. The Company's access to these collateral items is generally established through the maintenance of recorded liens or, in the case of negotiable instruments, possession. No liability is currently established for the standby letters of credit.

The contractual amounts of financial instruments with off-balance-sheet risk at year end were as follows:

	2012		2011	
	Fixed Rate	Variable Rate	Fixed Rate	Variable Rate
	(in thousands)			
Commitments to make loans	\$ 2,490	\$ 3,546	\$ 4,413	\$ 9,458
Unused lines of credit	11,910	34,925	13,485	49,312
Standby letters of credit	1,085	1,176	746	2,707

Commitments to make loans are generally made for periods of one year or less.

#### NOTE 19 – FAIR VALUES

Fair value is the exchange price that would be received for an asset or paid to transfer a liability (exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. We use various valuation techniques to determine fair value, including market, income and cost approaches. There are three levels of inputs that may be used to measure fair values:

**Level 1:** Quoted prices (unadjusted) for identical assets or liabilities in active markets that an entity has the ability to access as of the measurement date, or observable inputs.

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

**Level 3:** Significant unobservable inputs that reflect an entity's own assumptions about the assumptions that market participants would use in pricing an asset or liability.

In certain cases, the inputs used to measure fair value may fall into different levels of the fair value hierarchy. When that occurs, we classify the fair value hierarchy on the lowest level of input that is significant to the fair value measurement. We used the following methods and significant assumptions to estimate fair value.

**Securities:** The fair values of securities available for sale are determined by obtaining quoted prices on nationally recognized securities exchanges, if available. This valuation method is classified as Level 1 in the fair value hierarchy. For securities where quoted prices are not available, fair values are calculated on market prices of similar securities, or 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. Matrix pricing relies on the securities' relationship to similarly traded securities, benchmark curves, and the benchmarking of like securities. Matrix pricing utilizes observable market inputs such as benchmark yields, reported trades, broker/dealer quotes, issuer spreads, two-sided markets, benchmark securities, bids, offers, reference data, and industry and economic events. In instances where broker quotes are used, these quotes are obtained from market makers or broker-dealers recognized to be market participants. This valuation method is classified as Level 2 in the fair value hierarchy. For securities where quoted prices or market prices of similar securities are not available, fair values are calculated using discounted cash flows or other market indicators. This valuation method is classified as Level 3 in the fair

value hierarchy. Discounted cash flows are calculated using spread to swap and LIBOR curves that are updated to incorporate loss severities, volatility, credit spread and optionality. During times when trading is more liquid, broker quotes are used (if available) to validate the model. Rating agency and industry research reports as well as defaults and deferrals on individual securities are reviewed and incorporated into the calculations.

**Impaired Loans:** An impaired loan is evaluated at the time the loan is identified as impaired and is recorded at fair value less costs to sell. Fair value is measured based on the value of the collateral securing the loan and is classified as Level 3 in the fair value hierarchy. Fair value is determined using several methods. Generally, the fair value of real estate is determined based on appraisals by qualified licensed appraisers. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach.

Adjustments are routinely made in the appraisal process by the appraisers to adjust for differences between the comparable sales and income data available. These routine adjustments are made to adjust the value of a specific property relative to comparable properties for variations in qualities such as location, size, and income production capacity relative to the subject property of the appraisal. Such adjustments are typically significant and result in a Level 3 classification of the inputs for determining fair value.

We routinely apply an internal discount to the value of appraisals used in the fair value evaluation of our impaired loans. The deductions to the appraisal take into account changing business factors and market conditions, as well as potential value impairment in cases where our appraisal date predates a likely change in market conditions. These deductions range from 10% for routine real estate collateral to 25% for real estate that is determined (1) to have a thin trading market or (2) to be specialized collateral. This is in addition to estimated discounts for cost to sell of six to ten percent.

We also apply discounts to the expected fair value of collateral for impaired loans where the likely resolution involves litigation or foreclosure. Resolution of this nature generally results in receiving lower values for real estate collateral in a more aggressive sales environment. We have utilized discounts ranging from 10% to 33% in our impairment evaluations when applicable.

Impaired loans are evaluated quarterly for additional impairment. We obtain updated appraisals on properties securing our loans when circumstances are warranted such as at the time of renewal or when market conditions have significantly changed. This determination is made on a property-by-property basis in light of circumstances in the broader economic climate and our assessment of deterioration of real estate values in the market in which the property is located. The first stage of our assessment involves management's inspection of the property in question. Management also engages in conversations with local real estate professionals, investors, and market makers to determine the likely marketing time and value range for the property. The second stage involves an assessment of current trends in the regional market. After thorough consideration of these factors, management will either internally evaluate fair value or order a new appraisal.

**Other Real Estate Owned (OREO) :** OREO is evaluated at the time of acquisition and recorded at fair value as determined by independent appraisal or internal market evaluation less cost to sell. Our quarterly evaluations of OREO for impairment are driven by property type. For smaller dollar single family homes, we consult with internal real estate sales staff and external realtors, investors, and appraisers. Based on these consultations, we determine asking prices for OREO properties we are marketing for sale. If the internally evaluated fair value is below our recorded investment in the property, appropriate write-downs are taken.

For larger dollar commercial real estate properties, we obtain a new appraisal of the subject property in connection with the transfer to other real estate owned. In some of these circumstances, an appraisal is in process at quarter end, and we must make our best estimate of the fair value of the underlying collateral based on our internal evaluation of the property, review of the most recent appraisal, and discussions with the currently engaged appraiser. We obtain updated appraisals on the anniversary date of ownership unless a sale is imminent.

We routinely apply an internal discount to the value of appraisals used in the fair value evaluation of our OREO. The deductions to the appraisal take into account changing business factors and market conditions, as well as potential value impairment in cases where our appraisal date predates a likely change in market conditions. These deductions range from 10% for routine real estate collateral to 25% for real estate that is determined (1) to have a thin trading market or (2) to be specialized collateral. This is in addition to estimated discounts for cost to sell of six to ten percent.

In 2011, management, with concurrence of the Board of Directors, determined that certain properties held in other real estate were not likely to be successfully disposed of in an acceptable time-frame using routine marketing efforts. It became apparent that certain properties were going to require extended holding periods to sell the properties at recent appraised values. These properties are primarily single and multi-family residential loan development properties. Given our change in strategy to reduce non-performing assets in an accelerated manner, management adjusted downward the valuations for single and multi-family residential loan development properties in our OREO portfolio to amounts below their individual appraised values.

Financial assets measured at fair value on a non-recurring basis are summarized below:

<b>Fair Value Measurements at December 31, 2012 Using</b>				
<b>(in thousands)</b>				
<b>Description</b>	<b>Carrying Value</b>	<b>Quoted Prices In Active Markets for Identical Assets (Level 1)</b>	<b>Significant Other Observable Inputs (Level 2)</b>	<b>Significant Unobservable Inputs (Level 3)</b>
<u>Available-for-sale securities</u>				
U.S. Government and federal agency	\$ 6,133	\$ —	\$ 6,133	\$ —
Agency mortgage-backed: residential	95,182	—	95,182	—
State and municipal	54,733	—	54,733	—
Corporate bonds	19,964	—	19,964	—
Other debt securities	618	—	—	618
Equity securities	1,846	1,846	—	—
Total	<u>\$ 178,476</u>	<u>\$ 1,846</u>	<u>\$ 176,012</u>	<u>\$ 618</u>

<b>Fair Value Measurements at December 31, 2011 Using</b>				
<b>(in thousands)</b>				
<b>Description</b>	<b>Carrying Value</b>	<b>Quoted Prices In Active Markets for Identical Assets (Level 1)</b>	<b>Significant Other Observable Inputs (Level 2)</b>	<b>Significant Unobservable Inputs (Level 3)</b>
<u>Available-for-sale securities</u>				
U.S. Government and federal agency	\$ 11,643	\$ —	\$ 11,643	\$ —
Agency mortgage-backed: residential	99,475	—	99,475	—
State and municipal	38,062	—	36,889	1,173
Corporate bonds	7,332	—	7,332	—
Other debt securities	606	—	—	606
Equity securities	1,715	1,715	—	—
Total	<u>\$ 158,833</u>	<u>\$ 1,715</u>	<u>\$ 155,339</u>	<u>\$ 1,779</u>

There were no transfers between Level 1 and Level 2 during 2012 or 2011.

The table below presents a reconciliation of all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the periods ended December 31, 2012 and 2011:

	State and Municipal Securities		Other Debt Securities	
	2012	2011	2012	2011
	(in thousands)			
Balances of recurring Level 3 assets at January 1	\$ 1,173	\$ —	\$ 606	\$ 572
Total gain (loss) for the period:				
Included in other comprehensive income (loss)	—	—	12	34
Transfers into Level 3	—	1,173	—	—
Sales	(1,173)	—	—	—
Balance of recurring Level 3 assets at September 30	<u>\$ —</u>	<u>\$ 1,173</u>	<u>\$ 618</u>	<u>\$ 606</u>

The fair value for five municipal securities with fair values of \$1.2 million as of December 31, 2011 were transferred out of Level 2 and into Level 3 because of a lack of observable market data for these investments due to a decrease in market activity for these securities. Our policy is to recognize transfers as of the end of the reporting period. As a result, the fair value for these municipal securities was transferred on December 31, 2011.

Level 3 state and municipal securities valuations are supported by analysis prepared by an independent third party. Their approach to determining fair value involves using recently executed transactions for similar securities and market quotations for similar securities. As securities of this type are not rated by the rating agencies and trading volumes are thin, it was determined that these were valued using Level 3 inputs. We sold our Level 3 municipal securities in the second quarter of 2012 and had no securities of this nature at December 31, 2012.

Our other debt security valuation is determined internally by calculating discounted cash flows using the security's coupon rate of 6.5% and an estimated current market rate of 10.0% based upon the current yield curve plus spreads that adjust for volatility, credit risk, and optionality. We also consider the issuer(s) publicly filed financial information as well as assumptions regarding the likelihood of deferrals and defaults.

Financial assets measured at fair value on a non-recurring basis are summarized below:

Description	Fair Value Measurements at December 31, 2012 Using			
	Carrying Value	Quoted Prices In Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>Impaired loans:</b>				
Commercial	\$ 3,799	\$ —	\$ —	\$ 3,799
Commercial real estate:				
Construction	23,912	—	—	23,912
Farmland	5,722	—	—	5,722
Other	72,793	—	—	72,793
Residential real estate:				
Multi-family	13,263	—	—	13,263
1-4 Family	25,094	—	—	25,094
Consumer	74	—	—	74
Agriculture	5	—	—	5
Other	513	—	—	513
<b>Other real estate owned, net:</b>				
Commercial real estate:				
Construction	22,323	—	—	22,323
Farmland	602	—	—	602
Other	15,175	—	—	15,175
Residential real estate:				
Multi-family	195	—	—	195
1-4 Family	5,376	—	—	5,376





Description	Fair Value Measurements at December 31, 2011 Using			
	Carrying Value	Quoted Prices In Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>Impaired loans:</b>				
Commercial	\$ 2,653	\$ —	\$ —	\$ 2,653
Commercial real estate:				
Construction	15,899	—	—	15,899
Farmland	6,288	—	—	6,288
Other	75,128	—	—	75,128
Residential real estate:				
Multi-family	3,758	—	—	3,758
1-4 Family	21,648	—	—	21,648
Other	532	—	—	532
<b>Other real estate owned, net:</b>				
Commercial real estate:				
Construction	31,280	—	—	31,280
Farmland	715	—	—	715
Other	6,364	—	—	6,364
Residential real estate:				
1-4 Family	3,090	—	—	3,090

Impaired loans, which are measured for impairment using the fair value of the collateral for collateral dependent loans, had a carrying amount of \$152.2 million, with a valuation allowance of \$20.0 million, at December 31, 2012, resulting in an additional provision for loan losses of \$13.1 million for the year ended December 31, 2012. At December 31, 2011, impaired loans had a carrying amount of \$138.2 million, with a valuation allowance of \$12.3 million, resulting in an additional provision for loan losses of \$10.1 million for the year ended December 31, 2011.

Other real estate owned, which is measured at the lower of carrying or fair value less costs to sell, had a net carrying amount of \$43.7 million as of December 31, 2012, compared with \$41.4 million at December 31, 2011. Write-downs of \$7.2 million and \$34.9 million were recorded on other real estate owned for the years ended December 31, 2012 and 2011, respectively.

The following table presents qualitative information about level 3 fair value measurements for financial instruments measured at fair value on a non-recurring basis at December 31, 2012:

	Fair Value (in thousands)	Valuation Technique(s)	Unobservable Input(s)	Range (Weighted Average)
Impaired loans – Commercial	\$ 3,799	Market value approach	Adjustment for receivables and inventory discounts	16% - 32% (24%)
Impaired loans – Commercial real estate	\$ 89,461	Sales comparison approach	Adjustment for differences between the comparable sales	0% - 69% (19%)
Impaired loans – Residential real estate	\$ 38,357	Sales comparison approach	Adjustment for differences between the comparable sales	0% - 38% (15%)
Other real estate owned – Commercial real estate	\$ 38,100	Sales comparison approach Income approach	Adjustment for differences between the comparable sales Discount or capitalization rate	3% - 50% (18%) 9% - 16% (12%)
Other real estate owned – Residential real estate	\$ 5,571	Sales comparison approach	Adjustment for differences between the comparable sales	0% - 30% (9%)



Carrying amount and estimated fair values of financial instruments were as follows at year-end 2012:

	Carrying Amount	Fair Value Measurements at December 31, 2012 Using			
		Level 1	Level 2	Level 3	Total
		(in thousands)			
Financial assets					
Cash and cash equivalents	\$ 49,572	\$ 41,938	\$ 7,634	\$ —	\$ 49,572
Securities available for sale	178,476	1,846	176,012	618	178,476
Federal Home Loan Bank stock	10,072	N/A	N/A	N/A	N/A
Mortgage loans held for sale	507	—	507	—	507
Loans, net	842,412	—	—	853,996	853,996
Accrued interest receivable	5,138	—	1,150	3,988	5,138
Financial liabilities					
Deposits	\$ 1,065,059	\$ 114,310	\$ 955,216	\$ —	\$ 1,069,526
Securities sold under agreements to repurchase	2,634	—	2,634	—	2,634
Federal Home Loan Bank advances	5,604	—	5,607	—	5,607
Subordinated capital notes	6,975	—	—	6,599	6,599
Junior subordinated debentures	25,000	—	—	13,821	13,821
Accrued interest payable	2,104	—	1,173	931	2,104

Carrying amount and estimated fair values of financial instruments were as follows at year-end 2011:

	Carrying Amount	Fair Value Measurements at December 31, 2011 Using			
		Level 1	Level 2	Level 3	Total
		(in thousands)			
Financial assets					
Cash and cash equivalents	\$ 105,962	\$ 93,877	\$ 12,085	\$ —	\$ 105,962
Securities available for sale	158,833	1,715	155,339	1,779	158,833
Federal Home Loan Bank stock	10,072	N/A	N/A	N/A	N/A
Mortgage loans held for sale	694	—	694	—	694
Loans, net	1,083,444	—	—	1,093,456	1,093,456
Accrued interest receivable	6,682	—	970	5,712	6,682
Financial liabilities					
Deposits	\$ 1,323,763	\$ 111,118	\$ 1,221,015	\$ —	\$ 1,332,133
Securities sold under agreements to repurchase	1,738	—	1,738	—	1,738
Federal Home Loan Bank advances	7,116	—	7,015	—	7,015
Subordinated capital notes	7,650	—	—	7,110	7,110
Junior subordinated debentures	25,000	—	—	19,765	19,765
Accrued interest payable	1,732	—	1,510	222	1,732

The methods and assumptions used to estimate fair value are described as follows:

**(a) Cash and Cash Equivalents**

The carrying amounts of cash and short-term instruments approximate fair values and are classified as either Level 1 or Level 2. Noninterest bearing deposits are Level 1 whereas interest bearing due from bank accounts and fed funds sold are Level 2.

**(b) FHLB Stock**

It is not practical to determine the fair value of FHLB stock due to restrictions placed on its transferability.

**(c) Loans, Net**

Fair values of loans, excluding loans held for sale, are estimated as follows: For variable rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values resulting in a Level 3 classification. Fair values for other loans are estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality resulting in a Level 3 classification. Impaired loans are valued at the lower of cost or fair value as described previously. The methods utilized to estimate the fair value of loans do not necessarily represent an exit price.

**(d) Mortgage Loans Held for Sale**

The fair value of loans held for sale is estimated based upon binding contracts and quotes from third party investors resulting in a Level 2 classification.

**(e) Deposits**

The fair values disclosed for non-interest bearing deposits are, by definition, equal to the amount payable on demand at the reporting date resulting in a Level 1 classification. The carrying amounts of variable rate interest bearing deposits approximate their fair values at the reporting date resulting in a Level 2 classification. Fair values for fixed rate interest bearing deposits are estimated using a discounted cash flows calculation that applies interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities on time deposits resulting in a Level 2 classification.

**(f) Securities Sold Under Agreements to Repurchase**

The carrying amounts of borrowings under repurchase agreements approximate their fair values resulting in a Level 2 classification.

**(g) Other Borrowings**

The fair values of the Company's FHLB advances are estimated using discounted cash flow analyses based on the current borrowing rates resulting in a Level 2 classification.

The fair values of the Company's subordinated capital notes and junior subordinated debentures are estimated using discounted cash flow analyses based on the current borrowing rates for similar types of borrowing arrangements resulting in a Level 3 classification.

**(h) Accrued Interest Receivable/Payable**

The carrying amounts of accrued interest approximate fair value resulting in a Level 2 or Level 3 classification based on the level of the asset or liability with which the accrual is associated.

**NOTE 20 – STOCK PLANS AND STOCK BASED COMPENSATION**

The Company has a stock option plan and a stock incentive plan. On February 23, 2006, the Company adopted the Porter Bancorp, Inc. 2006 Stock Incentive Plan. The 2006 Plan permits the issuance of up to 400,000 shares of the Company's common stock upon the exercise of stock options or upon the grant of stock awards. As of December 31, 2012, the Company had granted 153,316 unvested shares net of forfeitures and vesting under the stock incentive plan. Shares issued under the plan vest annually on the anniversary date of the grant over two to ten years. The Company has 142,663 shares remaining available for issue under the plan. All shares issued under the above mentioned plans came from authorized and unissued shares.

On May 15, 2006, the Board of Directors approved the Porter Bancorp, Inc. 2006 Non-Employee Directors Stock Ownership Incentive Plan, which was approved by holders of the Company's voting common stock on June 8, 2006. On May 22, 2008, shareholders voted to amend the plan to change the form of incentive award from stock options to unvested shares. Under the terms of the plan, 100,000 shares are reserved for issuance to non-employee directors upon the exercise of stock options or upon the grant of unvested stock awards granted under the plan. Prior to the amendment, options were granted automatically under the plan at fair market value on the date of grant. The options vest over a three-year period and have a five year term. Unvested shares are granted automatically under the plan at fair market value on the date of grant and vest semi-annually on the anniversary date of the grant over three years.

On May 16, 2012, holders of the Company's voting common stock voted to further amend the 2006 Non-Employee Directors Stock Ownership Incentive Plan to award restricted shares having a fair market value of \$25,000 annually to each non-employee director, and to increase the number of shares issuable under the Directors' Plan from 100,000 shares to 400,000 shares. Shares issued under the amended plan vest semi-annually on the anniversary date of the grant over three years.

To date, the Company has issued 80,078 unvested shares to non-employee directors. At December 31, 2012, 295,712 shares remain available for issuance under this plan.

The fair value of the 2012 unvested shares issued to certain employees was \$169,000, or \$1.74 per weighted-average share. The fair value of the 2012 unvested shares issued to non-employee directors was \$155,000, or \$1.65 per share. The Company recorded \$442,000 and \$436,000 of stock-based compensation during 2012 and 2011, respectively, to salaries and employee benefits. There was no significant impact on compensation expense resulting from forfeited or expiring shares. We expect substantially all of the unvested shares outstanding at the end of the period will vest according to the vesting schedule. A deferred tax benefit of \$0 and \$153,000, respectively, was recognized related to this expense.

The following table summarizes unvested share activity as of and for the year indicated:

	<u>December 31, 2012</u>	
	<u>Unvested Shares</u>	<u>Weighted Average Grant Price</u>
Outstanding, beginning	100,226	\$ 13.21
Granted	191,140	1.69
Vested	(44,781)	8.89
Forfeited	(13,191)	15.22
Outstanding, ending	<u>233,394</u>	<u>\$ 4.49</u>

As of December 31, 2012, all stock options issued to non-employee directors had expired and none were exercised during their grant term. When granted, stock options have an exercise price that is equal to or greater than the fair market value of the Company's stock on the date the options were granted. Options granted generally become fully exercisable at the end of three years of continued employment. Options have a life of five years.

The following table summarizes stock option activity as of and for the year indicated:

	<u>December 31, 2012</u>	
	<u>Options</u>	<u>Weighted Average Exercise Price</u>
Outstanding, beginning	29,530	\$ 19.88
Forfeited	—	—
Expired	(29,530)	19.88
Outstanding, ending	<u>—</u>	<u>\$ —</u>

No options were exercised during 2012. The Company recorded no stock option compensation expense during the year ended December 31, 2012. No options were modified during the period. As of December 31, 2012, no stock options issued by the Company had been exercised, and all granted options had expired.

Unrecognized stock based compensation expense related to unvested shares for 2013 and beyond is estimated as follows (in thousands):

2013	\$	400
2014		300
2015		157
2016		57
2017 & thereafter		22

## NOTE 21 – EARNINGS (LOSS) PER SHARE

The factors used in the basic and diluted earnings per share computation follow:

	<u>2012</u>	<u>2011</u>	<u>2010</u>
	<b>(in thousands, except share and per share data)</b>		
Net loss	\$ (32,932)	\$ (107,307)	\$ (4,384)
Less:			
Preferred stock dividends	(1,750)	(1,750)	(1,810)
Accretion of Series A preferred stock discount	(179)	(177)	(177)
Loss attributable to unvested shares	482	1,092	81
Loss attributable to Series C preferred	947	2,988	103
Net loss attributable to common shareholders, basic and diluted	<u>\$ (33,432)</u>	<u>\$ (105,154)</u>	<u>\$ (6,187)</u>
 <b>Basic</b>			
Weighted average common shares including unvested common shares and Series C Preferred outstanding	12,248,936	12,169,987	10,640,872
Less: Weighted average unvested common shares	(169,323)	(121,632)	(135,757)
Less: Weighted average Series C preferred shares	(332,894)	(332,894)	(171,616)
Weighted average common shares outstanding	<u>11,746,719</u>	<u>11,715,461</u>	<u>10,333,499</u>
Basic loss per common share	<u>\$ (2.85)</u>	<u>\$ (8.98)</u>	<u>\$ (0.60)</u>
 <b>Diluted</b>			
Add: Dilutive effects of assumed exercises of common and Preferred Series C stock warrants	—	—	—
Weighted average common shares and potential common shares	<u>11,746,719</u>	<u>11,715,461</u>	<u>10,333,499</u>
Diluted loss per common share	<u>\$ (2.85)</u>	<u>\$ (8.98)</u>	<u>\$ (0.60)</u>

Stock options for 29,530 shares of common stock for 2011, and 86,469 shares of common stock for 2010, were not considered in computing diluted earnings per common share because they were anti-dilutive. The Company had no outstanding stock options at December 31, 2012. Additionally, a warrant for the purchase of 330,561 shares of the Company's common stock at an exercise price of \$15.88 was outstanding at December 31, 2012, 2011 and 2010 but was not included in the diluted earnings per share computation as inclusion would have been anti-dilutive. Finally, warrants for the purchase of 1,380,437 shares of non-voting common stock at an exercise price of \$11.50 per share were outstanding at December 31, 2012, 2011, and 2010, but were not included in the diluted earnings per share computation as inclusion would have been anti-dilutive.

## NOTE 22 – PARENT COMPANY ONLY CONDENSED FINANCIAL INFORMATION

Condensed financial information of Porter Bancorp Inc. is presented as follows:

### CONDENSED BALANCE SHEETS

December 31,

	<u>2012</u>	<u>2011</u>
	<b>(in thousands)</b>	
<b>ASSETS</b>		
Cash and cash equivalents	\$ 995	\$ 2,564
Securities available-for-sale	2,464	2,321
Investment in banking subsidiary	71,711	103,083
Investment in and advances to other subsidiaries	776	776
Other assets	535	550
<b>Total assets</b>	<u>\$ 76,481</u>	<u>\$ 109,294</u>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Debt	\$ 25,775	\$ 25,775
Accrued expenses and other liabilities	3,516	990
Shareholders' equity	47,190	82,529
<b>Total liabilities and shareholders' equity</b>	<u>\$ 76,481</u>	<u>\$ 109,294</u>

## CONDENSED STATEMENTS OF OPERATIONS

Years ended December 31,

	<u>2012</u>	<u>2011</u>	<u>2010</u>
		<b>(in thousands)</b>	
Interest income	\$ 114	\$ 215	\$ 609
Dividends from subsidiaries	21	20	20
Other income	72	1,272	1,787
Interest expense	(692)	(652)	(659)
Other expense	(1,453)	(3,614)	(3,420)
Income (loss) before income tax and undistributed subsidiary income	(1,938)	(2,759)	(1,663)
Income tax expense (benefit)	864	468	(592)
Equity in undistributed subsidiary income (loss)	(30,130)	(104,080)	(3,313)
<b>Net income (loss)</b>	<u>\$ (32,932)</u>	<u>\$ (107,307)</u>	<u>\$ (4,384)</u>

## CONDENSED STATEMENTS OF CASH FLOWS

Years ended December 31,

	<u>2012</u>	<u>2011</u>	<u>2010</u>
		<b>(in thousands)</b>	
<b>Cash flows from operating activities</b>			
Net income (loss)	\$ (32,932)	\$ (107,307)	\$ (4,384)
Adjustments:			
Equity in undistributed subsidiary (income) loss	30,130	104,080	3,313
Income tax valuation allowance	—	1,095	—
Loss on sale of assets	—	—	84
Change in other assets	(21)	157	(219)
Change in other liabilities	776	(273)	225
Other	478	1,404	445
Net cash (used in) from operating activities	<u>(1,569)</u>	<u>(844)</u>	<u>(536)</u>
<b>Cash flows from investing activities</b>			
Investments in subsidiaries	—	(13,100)	(21,000)
Purchase of securities	—	—	(514)
Sales of securities	—	—	6,117
Net cash used in investing activities	<u>—</u>	<u>(13,100)</u>	<u>(15,397)</u>
<b>Cash flows from financing activities</b>			
Proceeds from sale of preferred stock, net	—	—	11,064
Proceeds from sale of common stock, net	—	—	19,476
Repurchase of common stock, net	—	—	—
Dividends paid on preferred stock	—	(1,319)	(1,847)
Dividends paid on common stock	—	(237)	(4,706)
Net cash from (used in) financing activities	<u>—</u>	<u>(1,556)</u>	<u>23,987</u>
Net change in cash and cash equivalents	(1,569)	(15,500)	8,054
Beginning cash and cash equivalents	2,564	18,064	10,010
Ending cash and cash equivalents	<u>\$ 995</u>	<u>\$ 2,564</u>	<u>\$ 18,064</u>



**NOTE 23 – QUARTERLY FINANCIAL DATA (UNAUDITED)**

	<u>Interest Income</u>	<u>Net Interest Income</u>	<u>Provision For Loan Losses</u>	<u>OREO Expense</u>	<u>Net Income (Loss)</u>	<u>Earnings (Loss) Per Common Share</u>	
						<u>Basic</u>	<u>Diluted</u>
(in thousands, except per share data)							
<b>2012</b>							
First quarter	\$ 15,755	\$ 11,454	\$ 3,750	\$ 1,257	\$ 1,502	\$ 0.08	\$ 0.08
Second quarter	14,812	10,795	4,000	1,205	151	(0.03)	(0.03)
Third quarter	13,987	10,132	25,500	5,204	(27,732) (1)	(2.29)	(2.29)
Fourth quarter	13,175	9,574	7,000	2,883	(6,853)	(0.59)	(0.59)
<b>2011</b>							
First quarter	\$ 19,616	\$ 13,768	\$ 5,100	\$ 1,367	\$ 799	\$ 0.03	\$ 0.03
Second quarter	19,198	13,441	13,700	22,109	(39,989) (2)	(3.33)	(3.33)
Third quarter	18,103	12,655	8,000	17,029	(12,162) (3)	(1.04)	(1.04)
Fourth quarter	16,637	11,651	35,800	7,020	(55,955) (4)	(4.64)	(4.64)

(1) Third quarter net income was lower than the previous quarter due to increased provision for loan losses expense during the quarter as a result of the continued decline in credit trends in our portfolio. The provision was also negatively impacted by a strategy change related to classified loans which we expected to more quickly remediate by litigation or foreclosure.

(2) Second quarter net income was lower than the previous quarter due to increased provision for loan losses expense during the quarter, higher fair value write-down adjustments on OREO, and a goodwill impairment charge of \$23.8 million.

(3) Third quarter net income was affected by OREO write-downs to prepare for a bulk sale of OREO.

(4) Fourth quarter net income was lower than previous quarters due to increased provision for loan losses expense during the quarter and the establishment of a deferred tax asset valuation allowance of \$31.7 million.

**NOTE 24 – CONTINGENCIES**

In 2010, the Company sold common shares, convertible preferred shares and warrants to purchase common shares to accredited investors for \$32 million in a private placement. In the placement, SBAV LP, an affiliate of Clinton Group, Inc. (“CGI”) purchased 456,524 common shares and warrants to purchase 228,262 common shares for \$10.93 per share for \$5,000,016. The numbers of shares and the warrant exercise price have been adjusted to reflect the Company’s 5% stock dividend in November 2010.

On July 11, 2011, CGI sent a letter to the Company, which was also attached as an exhibit to a Schedule 13D CGI filed with the Securities and Exchange Commission on the same date. In its letter CGI set forth concerns about the Company’s executive leadership team and its ability to properly manage the Bank’s operations, compliance with GAAP, financial disclosures and relationships with regulators, referencing the consent order PBI Bank entered into with the FDIC and the KDFI on June 24, 2011. CGI listed a number of steps it believed the Company must take to maximize shareholder value and comply with the consent order. In addition, CGI alleged “that it is likely that a number of representations and warranties made when the CGI affiliate entered into an agreement to purchase shares were false,” and demanded that the Company take immediate steps to “redress such breaches and make CGI and the other purchasers whole.”

On July 20, 2011, the Company’s board of directors established a new Risk Policy and Oversight Committee comprised of independent directors, to lead the Board’s oversight of the assessment and management of the risks of Porter Bancorp and PBI Bank. During the third quarter, the Oversight Committee undertook an investigation of the allegations raised in the CGI 13D to evaluate their merit and to ascertain the reasonableness of the Bank’s allowance for loan losses and OREO valuations at the time of Clinton’s investment.

The Oversight Committee reported its conclusions to the Company’s board of directors in October 2011. While recognizing opportunities for procedural improvements existed in the Bank’s lending and non-performing asset administration, the Oversight Committee concluded that this did not rise to a level that would result in the financial statements, or representations and warranties with respect to the financial statements, being misleading to investors in the 2010 private placement offering of the Company’s stock. The Oversight Committee further concluded that investors were afforded ample opportunity and access to information for their due diligence, including documentation involving asset valuation estimates, on-site management discussions and additional inquiries during visits to the Company headquarters, and access to loan files of their choosing and the appraisals contained therein, and that the Company’s disclosures were adequate in all material respects.

On January 30, 2012, CGI delivered a demand to inspect the Company's records pursuant to the Kentucky Business Corporation Act. The Company provided records to CGI in accordance with Kentucky law.

On December 17, 2012, SBAV LP filed a lawsuit against Porter Bancorp, PBI Bank, J. Chester Porter and Maria L. Bouvette in New York state court. The proceeding was removed to New York federal district court on January 16, 2013. *SBAV LP v. Porter Bancorp, et al.*, Civ. Action 13 Civ. 0372 (S.D.N.Y). The complaint alleges violation of the Kentucky Securities Act, negligent misrepresentation and, against defendants Porter Bancorp and Bouvette, breach of contract. The plaintiff seeks damages in an amount in excess of \$4,500,000, or the difference between the \$5,000,016 purchase price and the value of the securities when sold by the plaintiff, plus interest at the applicable statutory rate, costs and reasonable attorneys' fees. The defendants have filed motions to dismiss the suit or, in the alternative, to transfer it to federal district court in Kentucky. We dispute the material factual allegations made in the complaint and intend to defend the plaintiff's claims vigorously. We have not accrued liability related to this matter as we believe we have meritorious defenses.

On June 18, 2010, three real estate development companies filed suit in Kentucky state court against PBI Bank and Managed Assets of Kentucky ("MAKY"). *Signature Point Condominiums LLC, et al. v. PBI Bank, et al.*, Jefferson Circuit Court, Case No 10-CI-04295. The plaintiffs had borrowed funds from PBI Bank to finance a real estate development project in Jefferson County, Kentucky. In March 2010, PBI agreed to release the plaintiffs and the guarantors on the loans related to the project, and in exchange the plaintiffs conveyed the real estate securing the loans to PBI Bank. PBI Bank also granted the plaintiffs a right of first refusal to repurchase a +/- 30 acre tract of land within the project. In May 2010, PBI Bank submitted to plaintiffs the required notice of its intent to sell the land subject to the right of first refusal. After plaintiffs declined to exercise their right of first refusal, PBI Bank sold the land to MAKY in June 2010 for \$3.8 million.

Plaintiffs filed suit shortly before the closing of the sale and recorded a lis pendens claiming an interest in the land, effectively preventing MAKY from taking clear title. Plaintiffs have asserted claims of fraud, breach of fiduciary duty, breach of the duty of good faith and fair dealing, tortious interference with prospective business advantage and conspiracy to commit fraud, negligence, and conspiracy against PBI Bank and MAKY. Plaintiffs are seeking to rescind the agreement conveying the project to PBI Bank, but only with respect to the +/- 30 acre tract of land. PBI has filed a counterclaim against the plaintiffs and a third party complaint against the guarantors, asserting claims of fraud. MAKY has asserted claims against the plaintiffs for slander of title and interference with business opportunities. PBI's position is that if the conveyance agreement is rescinded, then PBI's notes, mortgages, and guarantees as well as the obligations of the plaintiffs and guarantors under the loans, which total more than \$26 million, would all be reinstated. PBI would then seek to enforce its rights under such instruments. The matter is scheduled for trial in July 2013. The preliminary motions on procedural matters have been submitted and ruled on. We have not accrued liability related to this matter as we believe we have meritorious claims and defenses.

In the normal course of operations, we are defendants in various legal proceedings. We record contingent liabilities resulting from claims against us when a loss is assessed to be probable and the amount of the loss is reasonably estimable. Assessing probability of loss and estimating probable losses requires analysis of multiple factors, including in some cases judgments about the potential actions of third party claimants and courts. Recorded contingent liabilities are based on the best information available and actual losses in any future period are inherently uncertain. Currently, we do not believe that any of our pending legal proceedings or claims will have a material impact on our financial position or results of operations.

#### **Item 9 . Changes in and Disagreements With Accountants on Accounting and Financial Disclosure**

None

#### **Item 9A . Controls and Procedures**

Management is responsible for establishing and maintaining effective disclosure controls and procedures, as defined under Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934. As of December 31, 2012, an evaluation was performed under the supervision and with the participation of management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures.

As a result of regulatory examination and audit processes applied to our loan grading activities shortly before and after year end 2011, we determined that our internal process for assigning loan grades did not always establish an accurate grade for credit risk. Our internal control processes surrounding loan grades, which consist of a combination of internal and external loan review activities, identified and corrected grades for the majority of loans that were not initially graded correctly. However, our loan review had not sufficiently covered all loans subject to potential grading error throughout the 2011 fiscal year. In preparing our annual report on Form 10-K, we identified the extent to which our loan review controls did not operate and expanded the scope to cover the remainder of the portfolio and adjusted our allowance for loan losses to take the additional findings into consideration. Accordingly, we determined the controls regarding the determination of loan grades were not operating effectively as of December 31, 2011. Our management, overseen by the Audit Committee, worked throughout 2012 to implement steps to remediate the control weaknesses for loan grading discovered in the closing process for the year and quarter ended December 31, 2011.

These enhanced procedures and process improvements include:

- Completion of additional independent internal and external loan reviews of the portfolio to ensure accurate grading from March 2012 through December 2012.
- Review of the portfolio by assigned loan officer for proper grading.
- Analytical review of the portfolio by management based upon payment performance.
- Retention of John R. Davis to serve as Chief Credit Officer overseeing credit administration and credit quality policy and procedures.
- Implementation of a centralized loan administration and analysis team within the credit department to ensure more timely and regular review of grading, performance metrics, financial information, and collateral.

In addition to those procedures, management implemented the following controls to ensure the accuracy, consistency, and timeliness of loan grades:

- Implemented reporting on risk rating changes to the Bank's loan committee weekly and to the Board of Directors monthly.
- Ensured the risk rating assessment is a common discussion during the adjudication of any committee level loan request.
- Grade changes arising from specific file reviews or those recommended by the loan officer are routed to the loan review department manager to ensure accurate, consistent, and timely update.

During 2012, we took steps to resolve the material weakness by changing our procedures for loan grading, as discussed above. Based on our evaluation, management, including our Chief Executive Officer and our Chief Financial Officer, concluded that our disclosure controls and procedures were effective as of the end of the period covered by this report. There were no other changes in our internal control over financial reporting that occurred during the year ended December 31, 2012 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

#### **Item 9B . Other Information**

None

### **PART III**

#### **Item 10 . Directors, Executive Officers and Corporate Governance.**

We have adopted a code of ethics applicable to our Chief Executive Officer and our senior financial officers, which is posted on our website at <http://www.pbibank.com>. If we amend or waive any of the provisions of the Code of Ethics applicable to our Chief Executive Officer or senior financial officers, we intend to disclose the amendment or waiver on our website. We will provide to any person without charge, upon request, a copy of this Code of Ethics. You can request a copy by contacting Porter Bancorp, Inc., Chief Financial Officer, 2500 Eastpoint Parkway, Louisville, Kentucky, 40223, (telephone) 502-499-4800.

Additional information required by this Item 10 is omitted because we are filing a definitive proxy statement pursuant to Regulation 14A on or before April 30, 2013, which includes the required information. The required information contained in our proxy statement is incorporated herein by reference.

#### **Item 11 . Executive Compensation.**

The information required by this Item 11 is omitted because we are filing a definitive proxy statement pursuant to Regulation 14A on or before April 30, 2013, which includes the required information. The required information contained in our proxy statement is incorporated herein by reference.

**Item 12 . Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters**

The information required by this Item 12 is omitted because we are filing a definitive proxy statement pursuant to Regulation 14A on or before April 30, 2013, which includes the required information. The required information contained in our proxy statement is incorporated herein by reference.

**Item 13 . Certain Relationships and Related Transactions, and Director Independence.**

The information required by this Item 13 is omitted because we are filing a definitive proxy statement pursuant to Regulation 14A on or before April 30, 2013, which includes the required information. The required information contained in our proxy statement is incorporated herein by reference.

**Item 14 . Principal Accounting Fees and Services.**

The information required by this Item 14 is omitted because we are filing a definitive proxy statement pursuant to Regulation 14A on or before April 30, 2013, which includes the required information. The required information contained in our proxy statement is incorporated herein by reference.

## PART IV

### Item 15 . Exhibits and Financial Statement Schedules

(a) 1.The following financial statements are included in this Form 10-K:

Consolidated Balance Sheets as of December 31, 2012 and 2011  
Consolidated Statements of Operations for the Years Ended December 31, 2012, 2011, and 2010  
Consolidated Statements of Comprehensive Loss for the Years Ended December 31, 2012, 2011 and 2010  
Consolidated Statements of Change in Stockholders' Equity for the Years Ended December 31, 2012, 2011, and 2010  
Consolidated Statements of Cash Flows for the Years Ended December 31, 2012, 2011, and 2010  
Notes to Consolidated Financial Statements  
Report of Independent Registered Public Accounting Firm

(a) 2.List of Financial Statement Schedules

Financial statement schedules are omitted because the information is not applicable.

(a) 3.List of Exhibits

The Exhibit Index of this report is incorporated by reference. The compensatory plans or arrangement required to be filed as exhibits to this Form 10-K pursuant to Item 15(c) are noted with an asterisk in the Exhibit Index.

**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Company has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

**PORTER BANCORP, INC.**

February 28, 2013

By: /s/ Maria L. Bouvette  
Maria L. Bouvette  
Chairman & Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities indicated.

/s/ Maria L. Bouvette Chairman and Chief Executive Officer February 28, 2013  
Maria L. Bouvette

/s/ John T. Taylor President February 28, 2013  
John T. Taylor

/s/ Phillip W. Barnhouse Chief Financial Officer February 28, 2013  
Phillip W. Barnhouse

/s/ David L. Hawkins Director February 28, 2013  
David L. Hawkins

/s/ W. Glenn Hogan Director February 28, 2013  
W. Glenn Hogan

/s/ Sidney L. Monroe Director February 28, 2013  
Sidney L. Monroe

/s/ William G. Porter Director February 28, 2013  
William G. Porter

/s/ Stephen A. Williams Director February 28, 2013  
Stephen A. Williams

/s/ W. Kirk Wycoff Director February 28, 2013  
W. Kirk Wycoff

## EXHIBIT INDEX

<b>Exhibit No. (1)</b>	<b>Description</b>
3.1	Amended and Restated Articles of Incorporation of Registrant, dated December 7, 2005. Exhibit 3.1 to Form S-1 Registration Statement (Reg. No. 333-133198) filed April 11, 2006 is hereby incorporated by reference.
3.2	Articles of Amendment to the Amended and Restated Articles of Incorporation, dated November 18, 2008. Exhibit 3.1 to Form 8-K filed November 24, 2008 is hereby incorporated by reference.
3.3	Articles of Amendment to the Amended and Restated Articles of Incorporation, dated June 29, 2010. Exhibit 3.1 to the Registrant's Current Report on Form 8-K filed with the SEC on July 7, 2010 is hereby incorporated by reference.
3.4	Articles of Amendment to the Amended and Restated Articles of Incorporation, dated June 30, 2010. Exhibit 3.2 to the Registrant's Current Report on Form 8-K filed with the SEC on July 7, 2010 is hereby incorporated by reference.
3.5	Articles of Amendment to the Amended and Restated Articles of Incorporation, dated October 22, 2010. Exhibit 4.8 to Form S-3 Registration Statement (Reg. No. 333-170678) filed November 18, 2010 is hereby incorporated by reference.
3.6	Bylaws of the Registrant, dated November 30, 2005. Exhibit 3.2 to Form S-1 Registration Statement (Reg. No. 333-133198) filed April 11, 2006 is hereby incorporated by reference.
4.1	Warrant to purchase up to 299,829 shares. Exhibit 4.1 to Form 8-K filed November 24, 2008 is hereby incorporated by reference.
4.2	Securities Purchase Agreement between the Registrant and the Purchasers thereto, dated as of June 30, 2010. Exhibit 10.1 to the Registrant's Current Report on Form 8-K filed with the SEC on July 7, 2010 is hereby incorporated by reference.
4.3	Registration Rights Agreement between the Registrant and the Purchasers thereto, dated as of June 30, 2010. Exhibit 10.2 to the Registrant's Current Report on Form 8-K filed with the SEC on July 7, 2010 is hereby incorporated by reference.
4.4	Letter Agreement between the Registrant and SBAV LP, dated as of July 23, 2010. Exhibit 10 to the Registrant's Current Report on Form 8-K filed with the SEC on July 29, 2010 is hereby incorporated by reference.
10.1+	Porter Bancorp, Inc. Amended and Restated 2006 Stock Incentive Plan. Exhibit 10.2 to Form S-1 Registration Statement (Reg. No. 333-133198) filed April 11, 2006 is hereby incorporated by reference.
10.2+	Form of Porter Bancorp, Inc. Stock Option Award Agreement. Exhibit 10.3 to Form S-1 Registration Statement (Reg. No. 333-133198) filed April 11, 2006 is hereby incorporated by reference.
10.3+	Form of Porter Bancorp, Inc. Restricted Stock Award Agreement. Exhibit 10.4 to Form S-1 Registration Statement (Reg. No. 333-133198) filed April 11, 2006 is hereby incorporated by reference.
10.4+	Form of Ascencia Bank (now known as PBI Bank) Supplemental Executive Retirement Plan. Exhibit 10.5 to Form S-1 Registration Statement (Reg. No. 333-133198) filed April 11, 2006 is hereby incorporated by reference.
10.5+	Form of Amendment to PBI Bank Supplemental Executive Retirement Plan.
10.6+	Porter Bancorp, Inc. 2006 Non-Employee Directors Stock Ownership Incentive Plan, as amended May 22, 2008. Annex A Definitive Proxy Statement filed April 17, 2008 is hereby incorporated by reference.
10.7+	Amendment to Porter Bancorp, Inc. 2006 Non-Employee Directors Stock Ownership Incentive Plan, as amended May 22, 2008.
10.8	Promissory Installment Note of Maria L. Bouvette and J. Chester Porter, as borrowers, to David L. Hawkins, as lender. Exhibit 10.7 to Form S-1/A Registration Statement (Reg. No. 333-133198) filed May 24, 2006 is hereby incorporated by reference.
10.9	Letter Agreement, dated November 21, 2008 including the Securities Purchase Agreement – Standard Terms incorporated by reference therein, between the Company and the U.S. Treasury. Exhibit 10.1 to Form 8-K filed November 24, 2008 is hereby incorporated by reference.

**Exhibit No. (1) Description**

10.10	Form of Waiver of Senior Executive Officers. Exhibit 10.2 to Form 8-K filed November 24, 2008 is hereby incorporated by reference.
10.11+	Porter Bancorp, Inc. 2011 Incentive Compensation Bonus Plan (incorporated by reference to Exhibit 10.14 to 2011 Form 10K).
10.12	Consent with Federal Deposit Insurance Corporation and Kentucky Department of Financial Institutions dated June 24, 2011. Exhibit 99.1 to Form 8-K filed June 30, 2011.
21.1	List of Subsidiaries of Porter Bancorp, Inc.
23.1	Consent of Crowe Horwath LLP, Independent Registered Public Accounting Firm
31.1	Certification of Chief Executive Officer pursuant to Exchange Act Rules 13a-14 or 15d-14
31.2	Certification of Chief Financial Officer pursuant to Exchange Act Rules 13a-14 or 15d-14
32.1	Certification of Chief Executive Officer pursuant to Exchange Act Rules 13a-14(b) or 15d-14(b) and 18 U.S.C. Section 1350
32.2	Certification of Chief Financial Officer pursuant to Exchange Act Rules 13a-14(b) or 15d-14(b) and U.S.C. Section 1350
99.1	Certification of Principal Executive Officer pursuant to Section 30.15 of the U.S. Treasury's Interim Final Rule on TARP Standards for Compensation and Corporate Governance.
99.2	Certification of Principal Executive Officer pursuant to Section 30.15 of the U.S. Treasury's Interim Final Rule on TARP Standards for Compensation and Corporate Governance.
101	The following financial statements from the Company's Annual Report on Form 10K for the year ended December 31, 2012, formatted in XBRL: (i) Consolidated Balance Sheets, (ii) Consolidated Statements of Operations, (iii) Consolidated Statements of Comprehensive Income, (iv) Consolidated Statements of Changes in Stockholders' Equity, (v) Consolidated Statements of Cash Flows, (vi) Notes to Consolidated Financial Statements.

+ Management contract or compensatory plan or arrangement.

(1) The Company has other long-term debt agreements that meet the exclusion set forth in Section 601(b)(4)(iii)(A) of Regulation S-K. The Company hereby agrees to furnish a copy of such agreements to the Securities and Exchange Commission upon request.



**SUBSIDIARIES OF PORTER BANCORP, INC.**

<b>Direct Subsidiary</b>	<b>Jurisdiction of Organization</b>	<b>Does Business As</b>
PBI Bank	Kentucky	PBI Bank
Asencia Statutory Trust I	Connecticut	Asencia Statutory Trust I
Porter Statutory Trust II	Connecticut	Porter Statutory Trust II
Porter Statutory Trust III	Connecticut	Porter Statutory Trust III
Porter Statutory Trust IV	Connecticut	Porter Statutory Trust IV
PBIB Corporation, Inc.	Kentucky	PBIB Corporation, Inc.

<b>Indirect Subsidiary</b>	<b>Jurisdiction of Organization</b>	<b>Does Business As</b>	<b>Parent Entity</b>
PBI Title Services, LLC	Kentucky	PBI Title Services, LLC	PBI Bank
Durham-Mudd Insurance Agency, Inc.	Kentucky	Durham-Mudd Insurance Agency, Inc.	PBI Bank

**CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

We consent to the incorporation by reference in Registration Statement Nos. 333-143676 and 333-143678 on Form S-8 and Registration Statement No. 333-156281 and 333-170678 on Form S-3 of Porter Bancorp, Inc. of our report dated February 28, 2013 with respect to the consolidated financial statements of Porter Bancorp, Inc., which report appears in this Annual Report on Form 10-K of Porter Bancorp, Inc. for the year ended December 31, 2012.

Crowe Horwath LLP

Louisville, Kentucky  
February 28, 2013

**PORTER BANCORP, INC .**  
**RULE 13A-14(A) CERTIFICATION OF CHIEF EXECUTIVE OFFICER**

I, Maria L. Bouvette, Chief Executive Officer of Porter Bancorp, Inc. (the "Company"), certify that:

1. I have reviewed this Annual Report on Form 10-K of the Company;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

(a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

(b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

(c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

(a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Dated: February 28, 2013

/s/ Maria L. Bouvette

Maria L.  
Bouvette  
Chief Executive Officer

**PORTER BANCORP, INC .**  
**RULE 13A-14(A) CERTIFICATION OF CHIEF FINANCIAL OFFICER**

I, Phillip W. Barnhouse, Chief Financial Officer of Porter Bancorp, Inc. (the "Company"), certify that:

1. I have reviewed this Annual Report on Form 10-K of the Company;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Dated: February 28, 2013

/s/ Phillip W. Barnhouse  
Phillip W.  
Barnhouse  
Chief Financial Officer

**SECTION 906 CERTIFICATION**

In connection with the Annual Report on Form 10-K of Porter Bancorp, Inc. (the “Company”) for the annual period ended December 31, 2012, as filed with the Securities and Exchange Commission on the date hereof (the “Report”), I, Maria L. Bouvette, Chief Executive Officer of the Company, do hereby certify, in accordance with 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) The Report fully complies with the requirements of Section 13(a) or 15(d), as applicable, of the Securities Exchange Act of 1934, as amended; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

PORTER BANCORP, INC.

Dated: February 28, 2013

By: /s/ Maria L. Bouvette  
Maria L. Bouvette  
Chief Executive Officer

**SECTION 906 CERTIFICATION**

In connection with the Annual Report on Form 10-K of Porter Bancorp, Inc. (the "Company") for the annual period ended December 31, 2012, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Phillip W. Barnhouse, Chief Financial Officer of the Company, do hereby certify, in accordance with 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) The Report fully complies with the requirements of Section 13(a) or 15(d), as applicable, of the Securities Exchange Act of 1934, as amended; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

PORTER BANCORP, INC.

Dated: February 28, 2013

By: /s/ Phillip W. Barnhouse  
Phillip W. Barnhouse  
Chief Financial Officer

**PORTER BANCORP, INC .**  
**TARP CERTIFICATION OF CHIEF EXECUTIVE OFFICER**

I, Maria L. Bouvette, Chief Executive Officer of Porter Bancorp, Inc. (the “Company”), certify that:

- (1) The compensation committee (the “Compensation Committee”) of the Board of Directors (the “Board”) of the Company has met at least every six months during the prior fiscal year with the senior risk officers of the Company to discuss and evaluate senior executive officer compensation plans and employee compensation plans and the risks these plans pose to the Company;
- (2) The Compensation Committee has identified and limited the features in the senior executive officer compensation plans that could lead senior executive officers to take unnecessary and excessive risks that could threaten the value of the Company, has identified any features in the employee compensation plans that pose risks to the Company, and has limited those features to ensure that the Company is not unnecessarily exposed to risks;
- (3) The Compensation Committee has reviewed at least every six months the terms of each employee compensation plan and identified and limited the features in the plan that could encourage the manipulation of reported earnings of the Company to enhance the compensation of an employee;
- (4) The Compensation Committee will certify to these reviews;
- (5) The Compensation Committee will provide a narrative description of how it limited the features in (i) senior executive officer compensation plans that could lead senior executive officers to take unnecessary and excessive risks that could threaten the value of the Company, (ii) employee compensation plans to ensure that the Company is not unnecessarily exposed to risks, and (iii) employee compensation plans that could encourage the manipulation of reported earnings of the Company to enhance the compensation of an employee;
- (6) The Company has required that all bonuses, retention awards, and incentive compensation of the senior executive officers and next twenty most highly compensated employees be subject to a provision for recovery or “clawback” by the Company if the payments were based on materially inaccurate financial statements or any other materially inaccurate performance metric criteria;
- (7) The Company has prohibited any golden parachute payment to the senior executive officers and the next five most highly compensated employees. For this purpose, a golden parachute payment is any payment triggered by involuntary termination with or without cause; bankruptcy, insolvency or receivership of the Company; or a change in control of the Company;
- (8) The Company has limited bonuses, retention awards, and incentive compensation paid to or accrued by employees to whom the bonus payment limitation applies;
- (9) The Company will permit a non-binding shareholder resolution on the senior executive officer compensation disclosures provided under the Federal securities laws in accordance with any guidance, rules, and regulations promulgated by the SEC;
- (10) The Company and its employees have complied with the excessive or luxury expenditures policy, as defined in the regulations and guidance established under section 111 of EESA; and any expenses that, pursuant to the policy, required approval of the Board of Directors, a committee of the Board of Directors, a senior executive officer, or an executive officer with a similar level of responsibility were properly approved;
- (11) The Company will disclose the amount, nature, and justification for the offering of any perquisites whose total value exceeds \$25,000 for each of the employees subject to the bonus payment limitations;
- (12) The Company will disclose whether the Company, the Board, or the Compensation Committee has engaged a compensation consultant, and the services the compensation consultant or any affiliate provided;
- (13) The Company has prohibited any tax gross-ups on compensation to the senior executive officers and the next twenty most highly compensated employees;
- (14) The Company has substantially complied with any compensation requirements set forth in the agreement between the Company and the Treasury, as may have been amended;
- (15) The Company has submitted to Treasury a complete and accurate list of the senior executive officers and the twenty next most highly compensated employees for the current fiscal year with the non-senior executive officers ranked in descending order of level of annual compensation, and with the name, title, and employer of each senior executive officer and most highly compensated employee identified; and,
- (16) The officer certifying understands that a knowing and willful false or fraudulent statement made in connection with the certification may be punished by fine, imprisonment or both.

Dated: February 28, 2013

By: /s/ Maria L. Bouvette

Maria L. Bouvette  
Chief Executive Officer



**PORTER BANCORP, INC .**  
**TARP CERTIFICATION OF CHIEF FINANCIAL OFFICER**

I, Phillip W. Barnhouse, Chief Financial Officer of Porter Bancorp, Inc. (the “Company”), certify that:

- (1) The compensation committee (the “Compensation Committee”) of the Board of Directors (the “Board”) of the Company has met at least every six months during the prior fiscal year with the senior risk officers of the Company to discuss and evaluate senior executive officer compensation plans and employee compensation plans and the risks these plans pose to the Company;
- (2) The Compensation Committee has identified and limited the features in the senior executive officer compensation plans that could lead senior executive officers to take unnecessary and excessive risks that could threaten the value of the Company, has identified any features in the employee compensation plans that pose risks to the Company, and has limited those features to ensure that the Company is not unnecessarily exposed to risks;
- (3) The Compensation Committee has reviewed at least every six months the terms of each employee compensation plan and identified and limited the features in the plan that could encourage the manipulation of reported earnings of the Company to enhance the compensation of an employee;
- (4) The Compensation Committee will certify to these reviews;
- (5) The Compensation Committee will provide a narrative description of how it limited the features in (i) senior executive officer compensation plans that could lead senior executive officers to take unnecessary and excessive risks that could threaten the value of the Company, (ii) employee compensation plans to ensure that the Company is not unnecessarily exposed to risks, and (iii) employee compensation plans that could encourage the manipulation of reported earnings of the Company to enhance the compensation of an employee;
- (6) The Company has required that all bonuses, retention awards, and incentive compensation of the senior executive officers and next twenty most highly compensated employees be subject to a provision for recovery or “clawback” by the Company if the payments were based on materially inaccurate financial statements or any other materially inaccurate performance metric criteria;
- (7) The Company has prohibited any golden parachute payment to the senior executive officers and the next five most highly compensated employees. For this purpose, a golden parachute payment is any payment triggered by involuntary termination with or without cause; bankruptcy, insolvency or receivership of the Company; or a change in control of the Company;
- (8) The Company has limited bonuses, retention awards, and incentive compensation paid to or accrued by employees to whom the bonus payment limitation applies;
- (9) The Company will permit a non-binding shareholder resolution on the senior executive officer compensation disclosures provided under the Federal securities laws in accordance with any guidance, rules, and regulations promulgated by the SEC;
- (10) The Company and its employees have complied with the excessive or luxury expenditures policy, as defined in the regulations and guidance established under section 111 of EESA; and any expenses that, pursuant to the policy, required approval of the Board of Directors, a committee of the Board of Directors, a senior executive officer, or an executive officer with a similar level of responsibility were properly approved;
- (11) The Company will disclose the amount, nature, and justification for the offering of any perquisites whose total value exceeds \$25,000 for each of the employees subject to the bonus payment limitations;
- (12) The Company will disclose whether the Company, the Board, or the Compensation Committee has engaged a compensation consultant, and the services the compensation consultant or any affiliate provided;
- (13) The Company has prohibited any tax gross-ups on compensation to the senior executive officers and the next twenty most highly compensated employees;
- (14) The Company has substantially complied with any compensation requirements set forth in the agreement between the Company and the Treasury, as may have been amended;
- (15) The Company has submitted to Treasury a complete and accurate list of the senior executive officers and the twenty next most highly compensated employees for the current fiscal year, with the non-senior executive officers ranked in descending order of level of annual compensation, and with the name, title, and employer of each senior executive officer and most highly compensated employee identified; and,
- (16) The officer certifying understands that a knowing and willful false or fraudulent statement made in connection with the certification may be punished by fine, imprisonment or both.

Dated: February 28, 2013

By: /s/Phillip W. Barnhouse  
Phillip W. Barnhouse

Chief Financial Officer