

PEOPLES BANCORP OF NORTH CAROLINA INC
Form 10-Q
November 10, 2008

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

FORM 10-Q

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

For the quarterly period ended: September 30, 2008

OR

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

For the transition period from _____ to _____

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

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

000-27205
(Commission File No.)

56-2132396
(IRS Employer Identification No.)

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

28658
(Zip Code)

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

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

Yes X No

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

| | | |
|------------------|-------------------|-----------------------|
| Large Accelerate | Accelerated Filer | Non-Accelerated Filer |
|------------------|-------------------|-----------------------|

Filer

Smaller Reporting
Company

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

Yes No

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

5,539,056 shares of common stock, outstanding at October 31, 2008.

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Statements made in this Form 10-Q, other than those concerning historical information, should be considered forward-looking statements pursuant to the safe harbor provisions of the Securities Exchange Act of 1934 and the Private Securities Litigation Act of 1995. These forward-looking statements involve risks and uncertainties and are based on the beliefs and assumptions of management and on the information available to management at the time that this Form 10-Q was prepared. These statements can be identified by the use of words like “expect,” “anticipate,” “estimate,” and “believe,” variations of these words and other similar expressions. Readers should not place undue reliance on forward-looking statements as a number of important factors could cause actual results to differ materially from those in the forward-looking statements. Factors that could cause actual results to differ materially include, but are not limited to, (1) competition in the markets served by Peoples Bank, (2) changes in the interest rate environment, (3) general national, regional or local economic conditions may be less favorable than expected, resulting in, among other things, a deterioration in credit quality and the possible impairment of collectibility of loans, (4) legislative or regulatory changes, including changes in accounting standards, (5) significant changes in the federal and state legal and regulatory environments and tax laws, (6) the impact of changes in monetary and fiscal policies, laws, rules and regulations and (7) other risks and factors identified in the Company’s other filings with the Securities and Exchange Commission, including but not limited to those described in Peoples Bancorp of North Carolina, Inc.’s annual report on Form 10-K for the year ended December 31, 2007.

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

Consolidated Balance Sheets

| Assets | September 30, 2008 (Unaudited) | December 31, 2007 |
|--|--------------------------------------|----------------------|
| Cash and due from banks | \$ 24,929,113 | 26,108,437 |
| Interest bearing deposits | 18,822,322 | 1,539,190 |
| Federal funds sold | 2,463,000 | 2,152,000 |
| Cash and cash equivalents | 46,214,435 | 29,799,627 |
| Investment securities available for sale | 115,845,961 | 120,968,358 |
| Other investments | 6,302,809 | 6,433,947 |
| Total securities | 122,148,770 | 127,402,305 |
| Loans | 765,103,676 | 722,276,948 |
| Less allowance for loan losses | (9,762,716) | (9,103,058) |
| Net loans | 755,340,960 | 713,173,890 |
| Premises and equipment, net | 18,531,551 | 18,234,393 |
| Cash surrender value of life insurance | 6,958,703 | 6,776,379 |
| Accrued interest receivable and other assets | 14,827,754 | 11,875,202 |
| Total assets | \$ 964,022,173 | 907,261,796 |
| Liabilities and Shareholders' Equity | | |
| Deposits: | | |
| Non-interest bearing demand | \$ 115,078,272 | 112,071,090 |
| NOW, MMDA & savings | 213,593,478 | 196,959,895 |
| Time, \$100,000 or more | 230,884,930 | 203,499,504 |
| Other time | 194,310,755 | 181,108,214 |
| Total deposits | 753,867,435 | 693,638,703 |
| Demand notes payable to U.S. Treasury | 1,600,000 | 1,600,000 |
| Securities sold under agreement to repurchase | 32,230,836 | 27,583,263 |
| FHLB borrowings | 77,000,000 | 87,500,000 |
| Junior subordinated debentures | 20,619,000 | 20,619,000 |
| Accrued interest payable and other liabilities | 5,478,633 | 6,219,248 |
| Total liabilities | 890,795,904 | 837,160,214 |
| Shareholders' equity: | | |

| | | |
|---|----------------|-------------|
| Preferred stock, no par value; authorized 5,000,000 shares; no shares issued and outstanding | - | - |
| Common stock, no par value; authorized 20,000,000 shares; issued and outstanding 5,589,056 shares in 2008 and 5,624,234 shares in 2007 | 48,142,244 | 48,651,895 |
| Retained earnings | 23,252,402 | 19,741,876 |
| Accumulated other comprehensive income | 1,831,623 | 1,707,811 |
| Total shareholders' equity | 73,226,269 | 70,101,582 |
| Total liabilities and shareholders' equity | \$ 964,022,173 | 907,261,796 |

See accompanying notes to consolidated financial statements.

PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

Consolidated Statements of Earnings

| | Three months ended September 30, | | Nine months ended September 30, | |
|---|-------------------------------------|---------------------|------------------------------------|---------------------|
| | 2008 (Unaudited) | 2007 (Unaudited) | 2008 (Unaudited) | 2007 (Unaudited) |
| Interest income: | | | | |
| Interest and fees on loans | \$ 12,734,326 | 14,095,485 | 38,407,058 | 41,466,693 |
| Interest on federal funds sold | 17,634 | 32,634 | 52,350 | 367,331 |
| Interest on investment securities: | | | | |
| U.S. Government agencies | 1,065,268 | 1,150,619 | 3,304,971 | 3,411,555 |
| States and political subdivisions | 224,765 | 220,344 | 667,546 | 661,536 |
| Other | 79,740 | 125,663 | 314,946 | 363,625 |
| Total interest income | 14,121,733 | 15,624,745 | 42,746,871 | 46,270,740 |
| Interest expense: | | | | |
| NOW, MMDA & savings deposits | 807,841 | 1,077,857 | 2,514,458 | 2,975,499 |
| Time deposits | 3,535,641 | 4,378,969 | 11,466,705 | 12,983,826 |
| FHLB borrowings | 891,083 | 964,334 | 2,721,868 | 2,781,347 |
| Junior subordinated debentures | 232,436 | 371,225 | 789,833 | 1,095,572 |
| Other | 159,575 | 245,997 | 513,324 | 543,468 |
| Total interest expense | 5,626,576 | 7,038,382 | 18,006,188 | 20,379,712 |
| Net interest income | 8,495,157 | 8,586,363 | 24,740,683 | 25,891,028 |
| Provision for loans losses | 1,035,000 | 296,000 | 2,107,000 | 1,253,000 |
| Net interest income after provision for loan losses | 7,460,157 | 8,290,363 | 22,633,683 | 24,638,028 |
| Non-interest income: | | | | |
| Service charges | 1,410,765 | 1,082,248 | 3,814,247 | 3,017,921 |
| Other service charges and fees | 574,937 | 488,737 | 1,842,339 | 1,423,461 |
| Loss on sale and write-down of securities | (140,335) | (367,430) | (140,335) | (561,832) |
| Mortgage banking income | 165,516 | 135,863 | 526,036 | 435,475 |
| Insurance and brokerage commissions | 103,612 | 177,140 | 329,987 | 408,704 |
| Miscellaneous | 391,284 | 490,602 | 1,541,826 | 1,543,955 |

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| | | | | |
|-----------------------------------|--------------|-----------|------------|------------|
| Total non-interest income | 2,505,779 | 2,007,160 | 7,914,100 | 6,267,684 |
| Non-interest expense: | | | | |
| Salaries and employee benefits | 3,889,129 | 3,235,765 | 11,434,589 | 9,907,668 |
| Occupancy | 1,227,959 | 1,204,188 | 3,652,236 | 3,518,721 |
| Other | 2,160,508 | 1,774,127 | 6,234,574 | 4,988,601 |
| Total non-interest expense | 7,277,596 | 6,214,080 | 21,321,399 | 18,414,990 |
| Earnings before income taxes | | | | |
| | 2,688,340 | 4,083,443 | 9,226,384 | 12,490,722 |
| Income taxes | 942,000 | 1,470,800 | 3,233,800 | 4,500,841 |
| Net earnings | \$ 1,746,340 | 2,612,643 | 5,992,584 | 7,989,881 |
| Basic earnings per share | \$ 0.31 | 0.46 | 1.07 | 1.40 |
| Diluted earnings per share | \$ 0.31 | 0.45 | 1.06 | 1.37 |
| Cash dividends declared per share | \$ 0.12 | 0.12 | 0.36 | 0.29 |

See accompanying notes to consolidated financial statements.

PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

Consolidated Statements of Comprehensive Income

| | Three months ended September 30, | | Nine months ended September 30, | |
|---|-------------------------------------|---------------------|------------------------------------|---------------------|
| | 2008 (Unaudited) | 2007 (Unaudited) | 2008 (Unaudited) | 2007 (Unaudited) |
| Net earnings | \$ 1,746,340 | 2,612,643 | 5,992,584 | 7,989,881 |
| Other comprehensive income (loss): | | | | |
| Unrealized holding gains (losses) on securities available for sale | (636,287) | 2,355,325 | (1,087,122) | 598,395 |
| Reclassification adjustment for losses on sales of securities available for sale included in net earnings | 140,335 | 367,430 | 140,335 | 561,832 |
| Unrealized holding gains (losses) on derivative financial instruments qualifying as cash flow hedges | 262,490 | 726,465 | 876,060 | 534,291 |
| Total other comprehensive income (loss), before income taxes | (233,462) | 3,449,220 | (70,727) | 1,694,518 |
| Income tax expense (benefit) related to other comprehensive income: | | | | |
| Unrealized holding gains (losses) on securities available for sale | (248,009) | 917,399 | (423,434) | 233,075 |
| Reclassification adjustment for losses on sales of securities available for sale included in net earnings | 54,661 | 143,114 | 54,661 | 218,834 |
| Unrealized holding gains (losses) on derivative financial instruments qualifying as cash flow hedges | 19,400 | 238,374 | 174,235 | 82,184 |

| | | | | |
|--|--------------|-----------|-----------|-----------|
| Total income tax expense (benefit) related to other comprehensive income | (173,948) | 1,298,887 | (194,538) | 534,093 |
| Total other comprehensive income (loss), net of tax | (59,514) | 2,150,333 | 123,811 | 1,160,425 |
| Total comprehensive income | \$ 1,686,826 | 4,762,976 | 6,116,395 | 9,150,306 |

See accompanying notes to consolidated financial statements.

PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows

Nine months ended September 30, 2008 and 2007

| | 2008 (Unaudited) | 2007 (Unaudited) |
|---|---------------------|---------------------|
| Cash flows from operating activities: | | |
| Net earnings | \$ 5,992,584 | 7,989,881 |
| Adjustments to reconcile net earnings to net cash provided by operating activities: | | |
| Depreciation, amortization and accretion | 1,213,576 | 1,152,024 |
| Provision for loan losses | 2,107,000 | 1,253,000 |
| Loss on sale and write-down of securities | 140,335 | 561,832 |
| Loss on sale of premises and equipment | 1,404 | - |
| Amortization of deferred gain on sale of premises | - | (9,967) |
| Loss on sale of repossessed assets | 133,885 | 136,759 |
| Stock compensation expense | 10,708 | 5,790 |
| Split-dollar life insurance expense | 44,827 | - |
| Change in: | | |
| Cash surrender value of life insurance | (182,324) | (181,582) |
| Other assets | (1,249,780) | (356,426) |
| Other liabilities | (1,267,891) | (293,081) |
| Net cash provided by operating activities | 6,944,324 | 10,258,230 |
| Cash flows from investing activities: | | |
| Purchases of investment securities available for sale | (33,484,971) | (13,925,092) |
| Proceeds from calls and maturities of investment securities available for sale | 14,142,487 | 4,903,721 |
| Proceeds from sales of investment securities available for sale | 23,444,994 | 8,362,525 |
| Purchases of other investments | (2,978,362) | (4,383,400) |
| Proceeds from sale of other investments | 3,109,500 | 4,923,000 |
| Net change in loans | (46,600,605) | (39,329,536) |
| Purchases of premises and equipment | (1,612,917) | (5,652,751) |
| Proceeds from sale of premises and equipment | 33,545 | - |
| Proceeds from sale of repossessed assets | 1,560,476 | 425,158 |
| Net cash used by investing activities | (42,385,853) | (44,676,375) |
| Cash flows from financing activities: | | |
| Net change in deposits | 60,228,732 | 41,628,240 |
| Net change in securities sold under agreement to repurchase | 4,647,573 | 13,897,542 |
| Proceeds from FHLB borrowings | 68,600,000 | 184,200,000 |
| Repayments of FHLB borrowings | (79,100,000) | (196,500,000) |

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| | | |
|--|---------------|-------------|
| Proceeds from exercise of stock options | 43,948 | 272,166 |
| Common stock repurchased | (548,775) | (2,275,200) |
| Cash paid in lieu of fractional shares | - | (3,354) |
| Cash dividends paid | (2,015,141) | (1,656,381) |
| Net cash provided by financing activities | 51,856,337 | 39,563,013 |
| Net change in cash and cash equivalent | 16,414,808 | 5,144,868 |
| Cash and cash equivalents at beginning of period | 29,799,627 | 21,500,318 |
| Cash and cash equivalents at end of period | \$ 46,214,435 | 26,645,186 |

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PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows, continued

Nine months ended September 30, 2008 and 2007

| | 2008 (Unaudited) | 2007 (Unaudited) |
|--|---------------------|---------------------|
| Supplemental disclosures of cash flow information: | | |
| Cash paid during the year for: | | |
| Interest | \$ 18,221,245 | 20,126,499 |
| Income taxes | \$ 3,261,800 | 4,224,000 |
| Noncash investing and financing activities: | | |
| Change in unrealized gain on investment securities available for sale, net of tax | \$ (578,013) | (708,319) |
| Change in unrealized gain (loss) on derivative financial instruments, net of tax | \$ 701,825 | (452,106) |
| Transfer of loans to other real estate and repossessions | \$ 3,209,451 | 478,424 |
| Financed portion of sale of other real estate | \$ 882,916 | - |
| Reclassification of an investment from other assets to securities available for sale | \$ - | 499,995 |
| Reclassification of an investment from other investments to securities available for sale | \$ - | 600,000 |
| EITF 06-4 retained earnings reduction | \$ 466,917 | - |

See accompanying notes to consolidated financial statements.

PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(1) Summary of Significant Accounting Policies

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

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

The Company’s accounting policies are fundamental to understanding management’s discussion and analysis of results of operations and financial condition. Many of the Company’s accounting policies require significant judgment regarding valuation of assets and liabilities and/or significant interpretation of the specific accounting guidance. A description of the Company’s significant accounting policies can be found in Note 1 of the notes to consolidated financial statements in the Company’s 2007 Annual Report to Shareholders which is Appendix A to the Proxy Statement for the May 1, 2008 Annual Meeting of Shareholders.

Recently Adopted Accounting Pronouncements

In September 2006, the Financial Accounting Standard Board (“FASB”) ratified the conclusions reached by the Emerging Issues Task Force (EITF) on EITF 06-4, “Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements.” This issue requires companies to recognize an obligation for either the present value of the entire promised death benefit or the annual “cost of insurance” required to keep the policy in force during the post-retirement years. EITF 06-4 was effective for the Company as of January 1, 2008. During first quarter 2008, the Company made a \$467,000 reduction to retained earnings for the cumulative effect of EITF 06-4 as of January 1, 2008 pursuant to the guidance of this pronouncement to record the portion of this benefit earned by participants prior to adoption of this pronouncement. During the third quarter of 2008, the Company recognized \$14,000 in expense associated with EITF 06-4. The Company has recognized \$45,000 in expense associated with EITF 06-4 for the nine months ended September 30, 2008.

In September 2006, the FASB issued SFAS No. 157, “Fair Value Measurements” (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements. SFAS 157 applies under other accounting pronouncements that require or permit fair value measurements. SFAS 157 was effective for the Company as of January 1, 2008. This standard had no effect on the Company’s financial position or results of operations.

SFAS 157 establishes a three-level fair value hierarchy for fair value measurements. Level 1 inputs are quoted prices in active markets for identical assets or liabilities that a company has the ability to access at the measurement date. Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. Level 3 inputs are unobservable inputs for the asset or liability. The Company’s fair value measurements for items measured at fair value at September 30, 2008 included:

| | Fair Value | | | |
|---|--------------------|-----------|-------------|-----------|
| | Measurements | Level 1 | Level 2 | Level 3 |
| | September 30, 2008 | Valuation | Valuation | Valuation |
| Investment securities available for sale | \$ 115,845,961 | 1,304,428 | 113,291,533 | 1,250,000 |
| Market value of derivatives (in other assets) | \$ 2,354,133 | - | 2,354,133 | - |

Fair values of investment securities available for sale are determined by obtaining quoted prices on nationally recognized securities exchanges when available. If quoted prices are not available, fair value is determined using matrix pricing, which is a mathematical technique used widely in the industry to value debt securities without

relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities. Fair values of derivative instruments are determined using widely accepted valuation techniques including discounted cash flow analysis on the expected cash flows of each derivative. This analysis reflects the contractual terms of the derivatives, including the period to maturity, and uses observable market-based inputs, including interest rate curves and implied volatilities.

The following is an analysis of fair value measurements of investment securities available for sale using Level 3, significant unobservable inputs, for the nine months ended September 30, 2008:

| | Investment Securities Available for Sale Level 3 Valuation |
|---|--|
| Balance, beginning of period | \$ 250,000 |
| Change in book value | - |
| Change in gain/(loss) realized and unrealized | - |
| Purchases/(sales) | 1,000,000 |
| Transfers in and/or out of Level 3 | - |
| Balance, end of period | \$ 1,250,000 |
| Change in unrealized gain/(loss) for assets still held in Level 3 | \$ 0 |

In accordance with the provisions of SFAS 114, the Company has specific loan loss reserves for loans that management has determined to be impaired. These specific reserves are determined on an individual loan basis based on management's current evaluation of the Company's loss exposure for each credit, given the appraised value of any underlying collateral. At September 30, 2008, the Company had specific reserves of \$867,000 in the allowance for loan losses on loans totaling \$7.3 million. The Company's September 30, 2008 fair value measurement for impaired loans is presented below:

| | Fair Value Measurements | | | Total Gains/(Losses) for the Nine Months Ended | |
|-------------------|----------------------------|----------------------|----------------------|--|-----------------------|
| | September 30, 2008 | Level 1 Valuation | Level 2 Valuation | Level 3 Valuation | September 30, 2008 |
| Impaired loans | \$ 6,406,548 | - | - | 6,406,548 | - |
| Other Real Estate | \$ 3,025,921 | - | - | 3,025,921 | - |

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities" (SFAS 159), which permits entities to choose to measure financial instruments and certain other instruments at fair value. SFAS 159 was effective for the Company as of January 1, 2008. The Company did not choose this option for any asset or liability, and therefore SFAS 159 did not have any effect on the Company's financial position, results of operations or disclosures.

Recently Issued Accounting Pronouncements

In February 2008, the FASB issued FSP FAS No. 140-3, "Accounting for Transfers of Financial Assets and Repurchase Financing Transactions." This FSP provides guidance on accounting for a transfer of a financial asset and a repurchase financing under SFAS No. 140, "Accounting for Transfers and Servicing of Financial Assets and

Extinguishments of Liabilities.” This FSP is not expected to have a material effect on the Company's financial position, results of operations or disclosures.

In February 2008, the FASB issued FSP FAS No. 157-1, “Application of FASB Statement No. 157 to FASB Statement No. 13 and Other Accounting Pronouncements That Address Fair Value Measurements for Purposes of Lease Classification or Measurement under Statement 13.” This FSP amends SFAS No. 157, “Fair Value Measurements,” to exclude SFAS No. 13, “Accounting for Leases” and other accounting pronouncements that address fair value measurements for purposes of lease classification or measurement under SFAS No. 13. This FSP is not expected to have any effect on the Company's financial position, results of operations or disclosures.

In February 2008, the FASB issued FSP FAS No. 157-2, “Effective Date of FASB Statement No. 157.” This FSP delays the effective date of SFAS No. 157, “Fair Value Measurements,” for nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). This FSP is not expected to have any effect on the Company's financial position, results of operations or disclosures.

In March 2008, the FASB issued SFAS No. 161, "Disclosures about Derivative Instruments and Hedging Activities," (SFAS 161). SFAS 161 is an amendment to SFAS No. 133, which provides for enhanced disclosures about how and why an entity uses derivatives and how and where those derivatives and related hedged items are reported in the entity's financial statements. SFAS 161 is effective for the Company as of January 1, 2009. As this is a disclosure related standard, this standard is not expected to have any effect on the Company's financial position or results of operations, and will result in additional disclosures related to the Company's derivatives.

In September 2008, the FASB issued FASB Staff Position (FSP) FAS No. 133-1 and FIN 45-4, "Disclosures about Credit Derivatives and Certain Guarantees: An Amendment of FASB Statement No. 133 and FASB Interpretation No. 45 and Clarification of the Effective Date of FASB Statement No. 161." This FSP is an amendment to SFAS No. 133, which provides for enhanced disclosure requirements for credit risk derivatives. This FSP is not expected to have any effect on the Company's financial position, results of operations or disclosures.

In October 2008, the FASB issued FSP FAS No. 157-3, "Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active." This FSP clarifies the application of SFAS No. 157, "Fair Value Measurements," in a market that is not active. This FSP is not expected to have any effect on the Company's financial position, results of operations or disclosures.

(2) Allowance for Loan Losses

The following is an analysis of the allowance for loan losses for the nine months ended September 30, 2008 and 2007:

| | 2008 | 2007 |
|------------------------------|--------------|-------------|
| Balance, beginning of period | \$ 9,103,058 | 8,303,432 |
| Provision for loan losses | 2,107,000 | 1,253,000 |
| Less: | | |
| Charge-offs | (1,667,687) | (1,178,791) |
| Recoveries | 220,345 | 309,392 |
| Net charge-offs | (1,447,342) | (869,399) |
| Balance, end of period | \$ 9,762,716 | 8,687,033 |

(3) Net Earnings Per Share

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

The reconciliation of the amounts used in the computation of both "basic earnings per share" and "diluted earnings per share" for the three and nine months ended September 30, 2008 is as follows:

For the three months ended September 30, 2008

| | Net Earnings | Common Shares | Per Share Amount |
|--------------------------------|--------------|---------------|------------------|
| Basic earnings per share | \$ 1,746,340 | 5,589,056 | \$ 0.31 |
| Effect of dilutive securities: | | | |
| Stock options | - | 46,726 | |
| Diluted earnings per share | \$ 1,746,340 | 5,635,782 | \$ 0.31 |

For the nine months ended September 30, 2008

| | Net Earnings | Common Shares | Per Share Amount |
|--------------------------------|--------------|------------------|---------------------|
| Basic earnings per share | \$ 5,992,584 | 5,600,109 | \$ 1.07 |
| Effect of dilutive securities: | | | |
| Stock options | - | 64,544 | |
| Diluted earnings per share | \$ 5,992,584 | 5,664,653 | \$ 1.06 |

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The reconciliation of the amounts used in the computation of both “basic earnings per share” and “diluted earnings per share” for the three and nine months ended September 30, 2007 is as follows:

For the three months ended September 30, 2007

| | Net Earnings | Common Shares | Per Share Amount |
|--------------------------------|--------------|---------------|------------------|
| Basic earnings per share | \$ 2,612,643 | 5,675,701 | \$ 0.46 |
| Effect of dilutive securities: | | | |
| Stock options | - | 108,387 | |
| Diluted earnings per share | \$ 2,612,643 | 5,784,088 | \$ 0.45 |

For the nine months ended September 30, 2007

| | Net Earnings | Common Shares | Per Share Amount |
|--------------------------------|--------------|---------------|------------------|
| Basic earnings per share | \$ 7,989,881 | 5,723,276 | \$ 1.40 |
| Effect of dilutive securities: | | | |
| Stock options | - | 114,293 | |
| Diluted earnings per share | \$ 7,989,881 | 5,837,570 | \$ 1.37 |

(4) Stock-Based Compensation

The Company has an Omnibus Stock Ownership and Long Term Incentive Plan (the “Plan”) whereby certain stock-based rights, such as stock options, restricted stock, performance units, stock appreciation rights, or book value shares, may be granted to eligible directors and employees. A total of 636,637 shares are currently reserved for possible issuance under this Plan. All rights must be granted or awarded within ten years from the May 13, 1999 effective date of the Plan.

Under the Plan, the Company granted incentive stock options to certain eligible employees in order that they may purchase Company stock at a price equal to the fair market value on the date of the grant. The options granted in 1999 vest over a five-year period. Options granted subsequent to 1999 vest over a three-year period. All options expire ten years after issuance. The Company did not grant any options during the three and nine months ended September 30, 2008 and 2007.

The Company granted 3,000 shares of restricted stock in 2007 at a grant date fair value of \$17.40 per share. The Company granted 1,750 shares of restricted stock during the nine months ended September 30, 2008 at a grant date fair value of \$12.80 per share. The Company recognizes compensation expense on the restricted stock over the period of time the restrictions are in place (three years from the grant date for the grants to date). The amount of expense recorded each period reflects the changes in the Company’s stock price during the period. As of September 30, 2008, there was \$40,000 of total unrecognized compensation cost related to restricted stock grants, which is expected to be recognized over a period of three years.

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

The following is a discussion of our financial position and results of operations and should be read in conjunction with the information set forth under Item 1A Risk Factors and the Company's consolidated financial statements and notes thereto on pages A-27 through A-56 of the Company's 2007 Annual Report to Shareholders which is Appendix A to the Proxy Statement for the May 1, 2008 Annual Meeting of Shareholders.

Introduction

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

Overview

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

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

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

The Company qualified as an accelerated filer in accordance with Rule 12b-2 of the Securities Exchange Act of 1934, effective December 31, 2006. Therefore, the Company was subject to the requirements of Section 404 of the Sarbanes-Oxley Act of 2002 (“SOX 404”). The Company incurred additional consulting and audit expenses in becoming compliant with SOX 404, and will continue to incur additional audit expenses to comply with SOX 404 when SOX 404 becomes applicable to smaller reporting companies. Management does not expect expenses related to SOX 404 to have a material impact on the Company’s financial statements. The Company qualified as a smaller reporting company effective June 30, 2008, due to a decrease in market capitalization. Management does not expect significant cost savings from this change in filing status, as certification of the effectiveness of internal controls by management will still be required.

The Emergency Economic Stabilization Act of 2008 was enacted in October 2008 in response to the current financial crisis. Two key components of this act are the Troubled Assets Relief Program (“TARP”) and the Capital Purchase Program (“CPP”). The TARP allows financial institutions to sell troubled assets to the U.S. Treasury. The Company will not participate in the TARP. The CPP allows qualifying financial institutions to issue senior preferred shares to the Treasury. The senior preferred shares will qualify as Tier 1 capital and will pay a cumulative dividend rate of 5 percent per annum for the first five years and will reset to a rate of 9 percent per annum after year five. The senior

preferred shares will be non-voting, other than class voting rights on matters that could adversely affect the shares. The senior preferred shares will be callable at par after three years. Prior to the end of three years, the senior preferred may be redeemed with the proceeds from a qualifying equity offering of any Tier 1 perpetual preferred or common stock. Treasury may also transfer the senior preferred shares to a third party at any time. In conjunction with the purchase of senior preferred shares, Treasury will receive warrants to purchase common stock with an aggregate market price equal to 15 percent of the senior preferred investment. The exercise price on the warrants will be the market price of the participating institution's common stock at the time of issuance, calculated on a 20-trading day trailing average. Companies participating in the CPP must adopt the Treasury's standards for executive compensation and corporate governance. The Company is currently evaluating its participation in the CPP.

The Bank opened a new office in Mecklenburg County, in Cornelius, North Carolina in June 2007 and a new office in Iredell County, in Mooresville, North Carolina in January 2008. Also in January 2008, the Bank opened a new Banco de la Gente office in Wake County, in Raleigh, North Carolina in a continuing effort to serve the Latino community. While there are no additional traditional offices planned in 2008, management will consider opening at least one new traditional office in Mecklenburg or Iredell counties in the next two to three years and additional Banco de la Gente offices in metropolitan areas in North Carolina.

Summary of Significant Accounting Policies

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

The Company's accounting policies are fundamental to understanding management's discussion and analysis of results of operations and financial condition. Many of the Company's accounting policies require significant judgment regarding valuation of assets and liabilities and/or significant interpretation of specific accounting guidance. A more complete description of the Company's significant accounting policies can be found in Note 1 of the Notes to Consolidated Financial Statements in the Company's 2007 Annual Report to Shareholders which is Appendix A to the Proxy Statement for the May 1, 2008 Annual Meeting of Shareholders. The following is a summary of the more subjective and complex accounting policies of the Company.

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

There are other complex accounting standards that require the Company to employ significant judgment in interpreting and applying certain of the principles prescribed by those standards. These judgments include, but are not limited to, the determination of whether a financial instrument or other contract meets the definition of a derivative in accordance with Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities." For a more complete discussion of policies, see the notes to the consolidated financial statements.

In September 2006, the Financial Accounting Standard Board ("FASB") ratified the conclusions reached by the Emerging Issues Task Force (EITF) on EITF 06-4, "Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements." This issue requires companies to recognize an

obligation for either the present value of the entire promised death benefit or the annual “cost of insurance” required to keep the policy in force during the post-retirement years. EITF 06-4 was effective for the Company as of January 1, 2008. During first quarter 2008, the Company made a \$467,000 reduction to retained earnings for the cumulative effect of EITF 06-4 as of January 1, 2008 pursuant to the guidance of this pronouncement to record the portion of this benefit earned by participants prior to adoption of this pronouncement. During the third quarter of 2008, the Company recognized \$14,000 in expense associated with EITF 06-4. The Company has recognized \$45,000 in expense associated with EITF 06-4 for the nine months ended September 30, 2008.

In September 2006, the FASB issued SFAS No. 157, “Fair Value Measurements” (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements. SFAS 157 applies under other accounting pronouncements that require or permit fair value measurements. SFAS 157 was effective for the Company as of January 1, 2008. This standard had no

effect on the Company's financial position or results of operations.

SFAS 157 establishes a three-level fair value hierarchy for fair value measurements. Level 1 inputs are quoted prices in active markets for identical assets or liabilities that a company has the ability to access at the measurement date. Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. Level 3 inputs are unobservable inputs for the asset or liability. The Company's fair value measurements for items measured at fair value at September 30, 2008 included:

| | Fair Value Measurements | | | |
|---|-------------------------|-------------------|-------------------|-------------------|
| | September 30, 2008 | Level 1 Valuation | Level 2 Valuation | Level 3 Valuation |
| Investment securities available for sale | \$ 115,845,961 | 1,304,428 | 113,291,533 | 1,250,000 |
| Market value of derivatives (in other assets) | \$ 2,354,133 | - | 2,354,133 | - |

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

The following is an analysis of fair value measurements of investment securities available for sale using Level 3, significant unobservable inputs, for the nine months ended September 30, 2008:

| | Investment Securities Available for Sale Level 3 Valuation |
|---|--|
| Balance, beginning of period | \$ 250,000 |
| Change in book value | - |
| Change in gain/(loss) realized and unrealized | - |
| Purchases/(sales) | 1,000,000 |
| Transfers in and/or out of Level 3 | - |
| Balance, end of period | \$ 1,250,000 |
| Change in unrealized gain/(loss) for assets still held in Level 3 | \$ 0 |

In accordance with the provisions of SFAS 114, the Company has specific loan loss reserves for loans that management has determined to be impaired. These specific reserves are determined on an individual loan basis based on management's current evaluation of the Company's loss exposure for each credit, given the appraised value of any underlying collateral. At September 30, 2008, the Company had specific reserves of \$867,000 in the allowance for loan losses on loans totaling \$7.3 million. The Company's September 30, 2008 fair value measurement for impaired loans is presented below:

| Fair Value Measurements | Level 1 Valuation | Level 2 Valuation | Level 3 Valuation | Total Gains/(Losses) for the |
|-------------------------|-------------------|-------------------|-------------------|------------------------------|
| September 30, 2008 | | | | |

| | | | | Nine Months Ended September 30, 2008 | |
|-------------------|----|-----------|---|---|-----------|
| Impaired loans | \$ | 6,406,548 | - | - | 6,406,548 |
| Other Real Estate | \$ | 3,025,921 | - | - | 3,025,921 |

In February 2007, the FASB issued SFAS No. 159, “The Fair Value Option for Financial Assets and Financial Liabilities” (SFAS 159), which permits entities to choose to measure financial instruments and certain other instruments at fair value. SFAS 159 was effective for the Company as of January 1, 2008. The Company did not choose this option for any asset or liability, and therefore SFAS 159 did not have any effect on the Company's financial position, results of operations or disclosures.

In February 2008, the FASB issued FSP FAS No. 140-3, “Accounting for Transfers of Financial Assets and Repurchase Financing Transactions.” This FSP provides guidance on accounting for a transfer of a financial asset and a repurchase financing under SFAS No. 140, “Accounting for Transfers and Servicing of Financial Assets and

Extinguishments of Liabilities.” This FSP is not expected to have a material effect on the Company's financial position, results of operations or disclosures.

In February 2008, the FASB issued FSP FAS No. 157-1, “Application of FASB Statement No. 157 to FASB Statement No. 13 and Other Accounting Pronouncements That Address Fair Value Measurements for Purposes of Lease Classification or Measurement under Statement 13.” This FSP amends SFAS No. 157, “Fair Value Measurements,” to exclude SFAS No. 13, “Accounting for Leases” and other accounting pronouncements that address fair value measurements for purposes of lease classification or measurement under SFAS No. 13. This FSP is not expected to have any effect on the Company's financial position, results of operations or disclosures.

In February 2008, the FASB issued FSP FAS No. 157-2, “Effective Date of FASB Statement No. 157.” This FSP delays the effective date of SFAS No. 157, “Fair Value Measurements,” for nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). This FSP is not expected to have any effect on the Company's financial position, results of operations or disclosures.

In March 2008, the FASB issued SFAS No. 161, “Disclosures about Derivative Instruments and Hedging Activities,” (SFAS 161). SFAS 161 is an amendment to SFAS No. 133, which provides for enhanced disclosures about how and why an entity uses derivatives and how and where those derivatives and related hedged items are reported in the entity's financial statements. SFAS 161 is effective for the Company as of January 1, 2009. As this is a disclosure related standard, this standard is not expected to have any effect on the Company's financial position or results of operations, and will result in additional disclosures related to the Company's derivatives.

In September 2008, the FASB issued FASB Staff Position (FSP) FAS No. 133-1 and FIN 45-4, “Disclosures about Credit Derivatives and Certain Guarantees: An Amendment of FASB Statement No. 133 and FASB Interpretation No. 45 and Clarification of the Effective Date of FASB Statement No. 161.” This FSP is an amendment to SFAS No. 133, which provides for enhanced disclosure requirements for credit risk derivatives. This FSP is not expected to have any effect on the Company's financial position, results of operations or disclosures.

In October 2008, the FASB issued FSP FAS No. 157-3, “Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active.” This FSP clarifies the application of SFAS No. 157, “Fair Value Measurements,” in a market that is not active. This FSP is not expected to have any effect on the Company's financial position, results of operations or disclosures.

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

Results of Operations

Summary. Net earnings for the third quarter of 2008 were \$1.7 million, or \$0.31 basic and diluted net earnings per share as compared to \$2.6 million, or \$0.46 basic net earnings per share and \$0.45 diluted net earnings per share for the same period one year ago. The decrease in net earnings is attributable to a decrease in net interest income, an increase in provision for loan losses and an increase in non-interest expense, which were partially offset by an increase in non-interest income.

The annualized return on average assets was 0.74% for the three months ended September 30, 2008 compared to 1.22% for the same period in 2007, and annualized return on average shareholders' equity was 9.40% for the three months ended September 30, 2008 compared to 15.35% for the same period in 2007.

Net earnings for the nine months ended September 30, 2008 were \$6.0 million, or \$1.07 basic net earnings per share and \$1.06 diluted net earnings per share as compared to \$8.0 million, or \$1.40 basic net earnings per share and \$1.37 diluted net earnings per share for the same period in 2007. The decrease in net earnings for the nine-month period ended September 30, 2008 is primarily attributable to a decrease in net interest income, an increase in the provision for loan losses and an increase in non-interest expense, which were partially offset by an increase in non-interest income.

The annualized return on average assets was 0.87% and 1.28% for the nine months ended September 30, 2008 and 2007, respectively. Annualized return on average shareholders' equity was 10.56% for the nine months ended September 30, 2008 compared to 15.41% for the same period in 2007.

Net Interest Income. Net interest income, the major component of the Company's net earnings, was \$8.5 million for the three months ended September 30, 2008, a decrease of 1% from the \$8.6 million earned in the same period in 2007.

This decrease is primarily attributable to a 275 basis point reduction in the Bank's prime commercial lending rate from September 30, 2007 to September 30, 2008. The decrease in loan interest income resulting from a decline in prime rate was partially offset by an increase in income from derivative instruments.

Interest income decreased \$1.5 million or 10% for the three months ended September 30, 2008 compared with the same period in 2007. The decrease was due to a 275 basis point reduction in the Bank's prime commercial lending rate, which was partially offset by an increase in the average outstanding balance of loans and income from interest rate derivative contracts. Net income from derivative instruments was \$907,000 for the three months ended September 30, 2008 when compared to a net loss of \$114,000 for the same period in 2007. The average yield on earning assets for the quarters ended September 30, 2008 and 2007 was 6.43% and 7.82%, respectively. During the quarter ended September 30, 2008, average loans increased \$84.8 million to \$757.4 million from \$672.6 million for the three months ended September 30, 2007. During the quarter ended September 30, 2008, average investment securities available-for-sale decreased \$7.0 million to \$113.5 million from \$120.5 million for the three months ended September 30, 2007.

Interest expense decreased \$1.4 million or 20% for the three months ended September 30, 2008 compared with the same period in 2007. The average rate paid on interest-bearing checking and savings accounts was 1.57% for the three months ended September 30, 2008 as compared to 2.27% for the same period of 2007. The average rate paid on certificates of deposits was 3.40% for the three months ended September 30, 2008 compared to 4.86% for the same period one year ago.

Net interest income for the nine-month period ended September 30, 2008 was \$24.7 million, a decrease of 4% from net interest income of \$25.9 million for the nine months ended September 30, 2007. This decrease is primarily attributable to a reduction in the Bank's prime commercial lending rate. The decrease in loan interest income resulting from a decline in prime rate was partially offset by an increase in income from derivative instruments.

Interest income decreased \$3.5 million or 8% to \$42.7 million for the nine months ended September 30, 2008 compared to \$46.3 million for the same period in 2007. The decrease was primarily due to a decrease in the average yield received on loans resulting from Federal Reserve interest rate decreases, which were partially offset by an increase in the average outstanding balance of loans and income from interest rate derivative contracts. Net income from derivative instruments was \$2.2 million for the nine months ended September 30, 2008 compared to a net loss of \$323,000 for the same period of 2007. The average yield earned on loans, including fees, was 6.95% for the nine months ended September 30, 2008 as compared to 8.47% for the same period of 2007. During the nine months ended September 30, 2008, average loans increased \$83.8 million to \$738.0 million from \$654.2 million for the same period in 2007. Average investment securities available for sale decreased \$4.5 million to \$115.9 million in the nine months ended September 30, 2008 compared to the same period in 2007. All other interest-earning assets including federal funds sold decreased to an average of \$12.6 million in the nine months ended September 30, 2008 from \$17.5 million in the same period in 2007. The tax equivalent yield on average earning assets decreased to 6.68% for the nine months ended September 30, 2008 as compared to 7.92% for the nine months ended September 30, 2007.

Interest expense decreased 12% to \$18.0 million for the nine months ended September 30, 2008 compared to \$20.4 million for the corresponding period in 2007. The decrease in interest expense was due to a decrease in the cost of funds to 3.29% for the nine months ended September 30, 2008 from 4.15% for the same period in 2007, partially offset by an increase in the volume of interest-bearing liabilities. The decrease in the cost of funds is primarily attributable to decreases in the average rate paid on interest-bearing deposits. The average rate paid on interest-bearing checking and savings accounts was 1.67% for the nine months ended September 30, 2008 as compared to 2.17% for the same period in 2007. The average rate paid on certificates of deposits was 3.83% for the nine months ended September 30, 2008 from 4.83% for the same period one year ago.

Provision for Loan Losses. For the three months ended September 30, 2008, a contribution of \$1.0 million was made to the provision for loan losses compared to \$296,000 for the same period one year ago. The increase in provision for loan losses is primarily attributable to a \$5.2 million increase in non-performing assets from September 30, 2007 to September 30, 2008, an increase in net charge-offs to \$914,000 from \$123,000 and increased loan growth. Net charge-offs in the quarter ended September 30, 2008 included charge-offs of \$501,000 on loans to a local builder whose loans were foreclosed upon in the same quarter. The Bank had \$3.2 million in Other Real Estate Owned at September 30, 2008, of which \$2.2 million was from loans to a local builder on three residential properties. The largest property is a home with a current book value of \$1.3 million after the Bank paid \$1.0 million to the holder of the first mortgage at foreclosure.

For the nine months ended September 30, 2008 a contribution of \$2.1 million was made to the provision for loan losses compared to a \$1.3 million contribution to the provision for loan losses for the nine months ended September 30, 2007. The increase in the provision for loan losses is primarily attributable to an increase in non-performing assets, net charge-offs and increased loan growth.

Non-Interest Income. Total non-interest income was \$2.5 million in the third quarter of 2008 as compared to \$2.0 million for the same period of 2007. Increases in components of non-interest income for the three months ended September 30, 2008 compared to the same period last year were primarily attributable to increases in service charges and fees and miscellaneous income. These increases in non-interest income were combined with a \$227,000 decrease in the loss on sale of securities in third quarter 2008 when compared to third quarter 2007. The loss on the sale and write-down of securities for the three months ended September 30, 2008 includes a \$300,000 write-down of an asset classified as investment securities available for sale. Management determined the market value of this investment had decreased significantly and was not a temporary impairment therefore a write-down was appropriate during the third quarter 2008. The remaining book balance of this asset is less than \$200,000. This asset is a publicly traded bank stock but is not Federal National Mortgage Association (“FNMA”) or Federal Home Loan Mortgage Corporation (“FHLMC”). The Company does not own any stock in FNMA or FHLMC. Service charges increased 30% to \$1.4 million for the three months ended September 30, 2008 when compared to the same period one year ago. Other service charges and fees increased 18% to \$575,000 for the three-month period ended September 30, 2008 when compared to the same period one year ago. The increase in service charges and fees is primarily attributable to growth in the Bank’s deposit base coupled with normal pricing changes. Mortgage banking income increased to \$166,000 during the three months ended September 30, 2008 from \$136,000 for the same period in 2007. Insurance and brokerage commissions decreased to \$104,000 during the three months ended September 30, 2008 from \$177,000 for the same period last year. Miscellaneous income was \$391,000 for the three months ended September 30, 2008, a 20% decrease from \$491,000 for the same period in 2007. This decrease in miscellaneous income is primarily due to a \$106,000 increase in losses on sale of Other Real Estate Owned in third quarter 2008 when compared to third quarter 2007.

Total non-interest income was \$7.9 million for the nine months ended September 30, 2008, a 26% increase over the \$6.3 million for the same period in 2007. This increase is primarily due to an increase in service charges and fees and mortgage banking income. These increases in non-interest income were combined with a \$421,000 decrease in the loss on sale and write-down of securities for the nine months ended September 30, 2008 when compared to the same period last year. Service charges increased 26% to \$3.8 million for the nine months ended September 30, 2008 when compared to the same period one year ago. Other service charges and fees increased 29% to \$1.8 million for the nine months ended September 30, 2008 when compared to the same period one year ago. The increase in service charges and fees is primarily attributable to growth in the Bank’s deposit base coupled with normal pricing changes. Mortgage banking income increased 21% to \$526,000 for the nine months ended September 30, 2008 when compared to the same period in 2007 due to an increase in brokered loan activity. Insurance and brokerage commissions decreased to \$330,000 for the nine months ended September 30, 2008 from \$409,000 for the same period last year. Miscellaneous income was \$1.5 million for the nine months ended September 30, 2008 and 2007.

Non-Interest Expense. Total non-interest expense increased 17% to \$7.3 million for the third quarter of 2008 as compared to \$6.2 million for the corresponding period in 2007. Salary and employee benefits totaled \$3.9 million for the three months ended September 30, 2008, an increase of 20% from the same period in 2007. The increase in salary and employee benefits is due to normal salary increases and expense associated with additional staff for new branches. Occupancy expense increased 2% for the quarter ended September 30, 2008. Other non-interest expense increased 22% to \$2.2 million for the three months ended September 30, 2008 as compared to the same period in 2007. This increase in other non-interest expense is primarily attributable to increase of \$115,000 in FDIC insurance expense and an increase of \$95,000 in deposit program expense.

Total non-interest expense was \$21.3 million for the nine months ended September 30, 2008, an increase of 16% over the same period in 2007. Salary and employee benefits totaled \$11.4 million for the nine months ended September 30, 2008, an increase of 15% over the same period in 2007. The increase in salary and employee benefits is primarily due to normal salary increases and expenses associated with additional staff for new branches. Occupancy expense increased 4% for the nine months ended September 30, 2008 due to an increase in furniture and equipment expense and lease expense associated with new branches. Other non-interest expense increased 25% to \$6.2 million for the

nine months ended September 30, 2008 as compared to the same period in 2007. This increase in other non-interest expense is primarily attributable to an increase of \$342,000 in FDIC insurance expense, an increase of \$283,000 in deposit program expense and an increase of \$93,000 in advertising expense.

Income Taxes. The Company reported income taxes of \$942,000 and \$1.5 million for the third quarters of 2008 and 2007, respectively. This represented effective tax rates of 35% and 36% for the respective periods.

The Company reported income taxes of \$3.2 million and \$4.5 million for the nine months ended September 30, 2008 and 2007, respectively. This represented an effective tax rate of 35% and 36% for the respective periods.

Analysis of Financial Condition

Investment Securities. Available-for-sale securities amounted to \$115.8 million at September 30, 2008 compared to \$121.0 million at December 31, 2007. Average investment securities available for sale for the nine months ended September 30, 2008 amounted to \$115.9 million compared to \$120.4 million for the year ended December 31, 2007.

Loans. At September 30, 2008, loans amounted to \$765.1 million compared to \$722.3 million at December 31, 2007, an increase of \$42.8 million. Average loans represented 85% and 83% of total earning assets for the nine months ended September 30, 2008 and the year ended December 31, 2007, respectively.

Although the Company has a diversified loan portfolio, a substantial portion of the loan portfolio is collateralized by real estate, which is dependent upon the real estate market. Real estate mortgage loans include both commercial and residential mortgage loans. At September 30, 2008, the Company had \$98.6 million in residential mortgage loans, \$91.0 million in home equity loans and \$269.2 million in commercial mortgage loans, which include \$214.8 million using commercial property as collateral and \$54.4 million using residential property as collateral. At September 30, 2008, commercial mortgage loans included \$126.5 million in speculative construction and development loans.

Residential mortgage loans include \$40.2 million made to customers in the Company's traditional banking offices and \$58.4 million in mortgage loans originated in the Company's Latino banking operations. All residential mortgage loans are originated as fully amortizing loans, with no negative amortization.

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

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

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

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

Management considers certain commercial loans with weak credit risk grades to be individually impaired and measures such impairment based upon available cash flows and the value of the collateral. Allowance or reserve levels are estimated for all other graded loans in the portfolio based on their assigned credit risk grade, type of loan and other matters related to credit risk.

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

The allowance for loan losses is comprised of three components: specific reserves, general reserves and unallocated reserves. After a loan has been identified as impaired, management measures impairment in accordance with

SFAS No. 114, "Accounting By Creditors for Impairment of a Loan." When the measure of the impaired loan is less than the recorded investment in the loan, the amount of the impairment is recorded as a specific reserve. These specific reserves are determined on an individual loan basis based on management's current evaluation of the Company's loss exposure for each credit, given the appraised value of any underlying collateral. Loans for which specific reserves are provided are excluded from the general allowance calculations as described below. At September 30, 2008 and December 31, 2007, the recorded investment in loans that were considered to be impaired under SFAS No. 114 was approximately \$7.3 million and \$8.0 million, respectively, with related allowance for loan losses of approximately \$867,000 and \$1.2 million at September 30, 2008 and December 31, 2007, respectively.

The general allowance reflects reserves established under the provisions of SFAS No. 5, "Accounting for Contingencies" for collective loan impairment. These reserves are based upon historical net charge-offs using the last three years' experience. This charge-off experience may be adjusted to reflect the effects of current conditions. The Bank considers information derived from its loan risk ratings and external data related to industry and general economic trends.

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

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

There were no significant changes in the estimation methods or fundamental assumptions used in the evaluation of the allowance for loan losses for the nine months ended September 30, 2008 as compared to the year ended December 31, 2007. Such revisions, estimates and assumptions are made in any period in which the supporting factors indicate that loss levels may vary from the previous estimates.

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

The allowance for loan losses at September 30, 2008 amounted to \$9.8 million or 1.28% of total loans compared to \$9.1 million or 1.26% of total loans at December 31, 2007.

The following table presents the percentage of loans assigned to each risk grade at September 30, 2008 and December 31, 2007.

LOAN RISK GRADE ANALYSIS:

| Risk Grade | Percentage of Loans By Risk Grade* | |
|----------------------------|---------------------------------------|------------|
| | 09/30/2008 | 12/31/2007 |
| Risk 1 (Excellent Quality) | 7.03% | 11.06% |

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| | | |
|-------------------------------|--------|--------|
| Risk 2 (High Quality) | 16.15% | 14.06% |
| Risk 3 (Good Quality) | 65.14% | 62.53% |
| Risk 4 (Management Attention) | 8.49% | 9.51% |
| Risk 5 (Watch) | 1.30% | 1.57% |
| Risk 6 (Substandard) | 0.70% | 0.13% |
| Risk 7 (Low Substandard) | 0.00% | 0.03% |
| Risk 8 (Doubtful) | 0.00% | 0.00% |
| Risk 9 (Loss) | 0.00% | 0.00% |

* Excludes non-accrual loans

At September 30, 2008 there were two relationships exceeding \$1.0 million (which totaled \$3.9 million) in the

Watch risk grade, two relationships exceeding \$1.0 million (which totaled \$4.0 million) in the Substandard risk grade and no relationships exceeding \$1.0 million in the Low Substandard risk grade. These customers continue to meet payment requirements and these relationships would not become non-performing assets unless they are unable to meet those requirements.

Non-performing Assets. Non-performing assets totaled \$12.6 million at September 30, 2008 or 1.30% of total assets, compared to \$8.5 million at December 31, 2007, or 0.93% of total assets. Non-accrual loans were \$9.0 million at September 30, 2008 and \$8.0 million at December 31, 2007. As a percentage of total loans outstanding, non-accrual loans were 1.18% at September 30, 2008 compared to 1.11% at December 31, 2007. The increase in non-accrual loans is primarily due to the inclusion of a \$824,000 rental property loan. The Bank had loans 90 days past due and still accruing at September 30, 2008 of \$522,000. At December 31, 2007, the Bank had no loans 90 days past due and still accruing. Other Real Estate Owned totaled \$3.0 million as of September 30, 2008 as compared to \$483,000 at December 31, 2007. At September 30, 2008, Other Real Estate Owned included eleven residential properties acquired through foreclosure totaling \$2.8 million, as compared to three residential properties acquired through foreclosure, totaling \$230,000 at December 31, 2007. Three residential properties, totaling \$2.2 million, in Other Real Estate Owned at September 30, 2008 were from loans to a local builder that were foreclosed upon in the third quarter. The largest property is a home with a current book value of \$1.3 million after the Bank paid \$1.0 million to the holder of the first mortgage at foreclosure. The Bank had \$1,000 in repossessed assets as of September 30, 2008 and no repossessed assets as of December 31, 2007.

Total non-performing loans, which include non-accrual loans and loans 90 days past due and still accruing, were \$9.5 million and \$8.0 million at September 30, 2008 and December 31, 2007, respectively. The ratio of non-performing loans to total loans was 1.24% at September 30, 2008, as compared to 1.11% at December 31, 2007.

Deposits. Total deposits at September 30, 2008 were \$753.9 million, an increase of \$60.3 million over deposits of \$693.6 million at December 31, 2007. Core deposits, which include non-interest bearing demand deposits, NOW, MMDA, savings and non-brokered certificates of deposits of denominations less than \$100,000, increased \$27.4 million to \$517.5 million at September 30, 2008 as compared to \$490.1 million at December 31, 2007. The Bank introduced remote deposit capture for customers in 2007 which has enabled the Bank to gather additional deposits from several existing customers and has been helpful in attracting new customers. Certificates of deposit in amounts greater than \$100,000 or more totaled \$230.9 million at September 30, 2008 as compared to \$203.5 million at December 31, 2007. At September 30, 2008, brokered deposits amounted to \$65.0 million as compared to \$53.9 million at December 31, 2007. Brokered deposits outstanding as of September 30, 2008 had a weighted average rate of 3.55% with a weighted average original term of seven months.

Borrowed Funds. Borrowings from the FHLB totaled \$77.0 million at September 30, 2008 compared to \$87.5 million at December 31, 2007. The average balance of FHLB borrowings for the nine months ended September 30, 2008 was \$79.4 million compared to \$80.1 million for the year ended December 31, 2007. At September 30, 2008, all of the Bank's FHLB borrowings had maturities exceeding one year. The FHLB has the option to convert \$72.0 million of the total advances to a floating rate and, if converted, the Bank may repay advances without a prepayment fee. The Company also has an additional \$5.0 million in variable rate convertible advances, which may be repaid without a prepayment fee if converted by the FHLB. The Company had no federal funds purchased as of September 30, 2008 or December 31, 2007.

Securities sold under agreements to repurchase were \$32.2 million at September 30, 2008 compared to \$27.6 million at December 31, 2007.

Junior Subordinated Debentures (related to Trust Preferred Securities). In June 2006 the Company formed a wholly owned Delaware statutory trust, PEBK Capital Trust II ("PEBK Trust II"), which issued \$20.0 million of guaranteed preferred beneficial interests in the Company's junior subordinated deferrable interest debentures. All of the common

securities of PEBK Trust II are owned by the Company. The proceeds from the issuance of the common securities and the trust preferred securities were used by PEBK Trust II to purchase \$20.6 million of junior subordinated debentures of the Company, which pay a floating rate equal to three-month LIBOR plus 163 basis points. The proceeds received by the Company from the sale of the junior subordinated debentures were used to repay in December 2006 the trust preferred securities issued by PEBK Capital Trust I in December 2001 and for general purposes. The debentures represent the sole asset of PEBK Trust II. PEBK Trust II is not included in the consolidated financial statements.

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

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

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

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

The Company's rate sensitive assets are those earning interest at variable rates and those with contractual maturities within one year. Rate sensitive assets therefore include both loans and available-for-sale securities. Rate sensitive liabilities include interest-bearing checking accounts, money market deposit accounts, savings accounts, time deposits and borrowed funds. The Company's balance sheet is asset-sensitive, meaning that in a given period there will be more assets than liabilities subject to immediate repricing as interest rates change in the market. Because the majority of the Company's loans are tied to the prime rate, they reprice more rapidly than rate sensitive interest-bearing deposits. During periods of rising rates, this results in increased net interest income. The opposite occurs during periods of declining rates. Average rate sensitive assets for the three months ended September 30, 2008 totaled \$866.5 million, exceeding average rate sensitive liabilities of \$731.1 million by \$135.4 million.

In order to assist in achieving a desired level of interest rate sensitivity, the Company entered into off-balance sheet contracts that are considered derivative financial instruments. As of September 30, 2008, the Company had cash flow hedges with a notional amount of \$200.0 million. These derivative instruments consist of four interest rate floor contracts and one interest rate swap contract. The interest rate floor contracts are used to hedge future cash flows from payments on the first \$150.0 million of certain variable rate loans against the downward effects of their repricing in the event of a decreasing rate environment during the terms of the interest rate floor contracts. If the prime rate falls below the contract rate during the term of the contract, the Company will receive payments based on notional amount times the difference between the contract rate and the weighted average prime rate for the quarter. No payments will be received by the Company if the weighted average prime rate is equal to or higher than the contract rate. The interest rate swap contract is used to convert \$50.0 million of variable rate loans to a fixed rate. Under the swap contract, the Company receives a fixed rate of 6.245% and pays a variable rate based on the current prime rate (5.00% at September 30, 2008) on the notional amount of \$50.0 million. The swap agreement matures in June 2011. The Company recognized \$2.2 million in interest income, net of premium amortization, from interest rate derivative contracts during the first nine months of 2008. Based on the current interest rate environment, it is expected the Company will continue to receive income on these interest rate contracts throughout 2008. The following tables present additional information on the Company's derivative financial instruments.

DERIVATIVE INSTRUMENTS AS OF SEPTEMBER 30, 2008

(Dollars in Thousands)

| Type of Derivative | Notional Amount | Contract | Premium |
|--------------------|-----------------|----------|---------|
|--------------------|-----------------|----------|---------|

| | | Rate | | Year-to-date Income (Net of Premium Amortization) |
|------------------------------|----|---------|--------|---|
| Interest rate floor contact* | \$ | - | - | \$ 151 |
| Interest rate floor contact | | 35,000 | 7.000% | 203 354 |
| Interest rate floor contact | | 45,000 | 7.500% | 562 555 |
| Interest rate floor contact | | 35,000 | 8.000% | 399 604 |
| Interest rate floor contact | | 35,000 | 7.250% | 634 339 |
| Interest rate swap contact | | 50,000 | 6.245% | - 209 |
| | \$ | 200,000 | | \$ 1,798 \$ 2,212 |

* Interest rate floor contract matured during third quarter 2008

FAIR VALUES OF DERIVATIVES DESIGNATED AS HEDGING INSTRUMENTS
UNDER SFAS 133

(Dollars in
Thousands)

| | Asset Derivatives | | | | Liability Derivatives | | | |
|------------------------------------|--------------------------|------------|-------------------------|------------|--------------------------|------------|-------------------------|------------|
| | As of September 30, 2008 | | As of December 31, 2007 | | As of September 30, 2008 | | As of December 31, 2007 | |
| | Balance Sheet Location | Fair Value | Balance Sheet Location | Fair Value | Balance Sheet Location | Fair Value | Balance Sheet Location | Fair Value |
| Interest rate derivative contracts | Other assets | \$ 2,354 | Other assets | \$ 1,907 | N/A | \$ - | N/A | \$ - |

Included in the rate sensitive assets are \$493.7 million in variable rate loans indexed to prime rate subject to immediate repricing upon changes by the Federal Open Market Committee ("FOMC"). The Bank utilizes interest rate floors on certain variable rate loans to protect against further downward movements in the prime rate. At September 30, 2008, the Bank had \$97.5 million in loans with interest rate floors. The floors were in effect on \$53.5 of these loans pursuant to the terms of the promissory notes on these loans. The weighted average rate on these loans is 1.04% higher than the indexed rate on the promissory notes without interest rate floors.

The Bank also had \$42,000 in loans that are tied to the prime rate that had 6.00% interest rate caps in effect due to the Soldiers and Sailors' Civil Relief Act.

Liquidity. The objectives of the Company's liquidity policy are to provide for the availability of adequate funds to meet the needs of loan demand, deposit withdrawals, maturing liabilities and to satisfy regulatory requirements. Both deposit and loan customer cash needs can fluctuate significantly depending upon business cycles, economic conditions and yields and returns available from alternative investment opportunities. In addition, the Company's liquidity is affected by off-balance sheet commitments to lend in the form of unfunded commitments to extend credit and standby letters of credit. As of September 30, 2008 such unfunded commitments to extend credit were \$170.1 million, while commitments in the form of standby letters of credit totaled \$4.6 million.

The Company uses several sources to meet its liquidity requirements. The primary source is core deposits, which includes demand deposits, savings accounts and non-brokered certificates of deposits of denominations less than \$100,000. The Company considers these to be a stable portion of the Company's liability mix and the result of on-going consumer and commercial banking relationships. As of September 30, 2008, the Company's core deposits totaled \$517.5 million, or 69% of total deposits.

The other sources of funding for the Company are through large denomination certificates of deposit, including brokered deposits, federal funds purchased and FHLB advances. The Bank is also able to borrow from the Federal Reserve Discount Window on a short-term basis. The Bank added to its liquidity at September 30, 2008 by increasing its borrowing capacity at the Federal Reserve. The Bank pledged loans receivable totaling \$294.4 million and now has the ability to borrow \$224.8 million from the Federal Reserve. The Bank has tested its access to the line with the Federal Reserve as part of its on-going liquidity management and now has immediate access to its line of credit.

At September 30, 2008, the Bank had a significant amount of deposits in amounts greater than \$100,000, including brokered deposits of \$59.5 million, which mature over the next seven months. The balance and cost of these deposits are more susceptible to changes in the interest rate environment than other deposits.

The Bank had a line of credit with the FHLB equal to 20% of the Bank's total assets, with an outstanding balance of \$77.0 million at September 30, 2008. The remaining availability at FHLB was \$73.8 million at September 30, 2008. The Bank also had the ability to borrow up to \$42.0 million for the purchase of overnight federal funds from four correspondent financial institutions as of September 30, 2008.

The liquidity ratio for the Bank, which is defined as net cash, interest bearing deposits with banks, federal funds sold, certain investment securities and certain FHLB advances available under the line of credit, as a percentage of net deposits (adjusted for deposit runoff projections) and short-term liabilities was 28.55% at September 30, 2008 and 28.04% at December 31, 2007. The minimum required liquidity ratio as defined in the Bank's Asset/Liability and Interest Rate Risk Management Policy is 20%.

Contractual Obligations and Off-Balance Sheet Arrangements. The Company's contractual obligations and other commitments as of September 30, 2008 and December 31, 2007 are summarized in the table below. The Company's

contractual obligations include the repayment of principal and interest related to FHLB advances and junior subordinated debentures, as well as certain payments under current lease agreements. Other commitments include commitments to extend credit. Because not all of these commitments to extend credit will be drawn upon, the actual cash requirements are likely to be significantly less than the amounts reported for other commitments below.

CONTRACTUAL OBLIGATIONS AND OTHER COMMITMENTS:

(Dollars in Thousands)

| | September 30, 2008 | December 31, 2007 |
|--|--------------------|----------------------|
| Contractual Cash Obligations | | |
| Long-term borrowings | \$ 77,000 | 77,000 |
| Junior subordinated debentures | 20,619 | 20,619 |
| Operating lease obligations | 4,755 | 5,290 |
| Total | \$ 102,374 | 102,909 |
| Other Commitments | | |
| Commitments to extend credit | \$ 170,743 | 190,654 |
| Standby letters of credit and financial guarantees written | 4,584 | 3,894 |
| Total | \$ 175,327 | 194,548 |

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

Capital Resources. Shareholders' equity at September 30, 2008 was \$73.2 million compared to \$70.1 million at December 31, 2007. At September 30, 2008 and December 31, 2007, unrealized gains (losses), net of taxes, amounted to unrealized gains of \$1.8 million and \$1.7 million, respectively. Annualized return on average equity for the nine months ended September 30, 2008 was 10.56% compared to 16.03% for the year ended December 31, 2007. Total cash dividends paid during the nine months ended September 30, 2008 amounted to \$2.0 million as compared to total cash dividends of \$1.7 million paid for the first nine months of 2007.

In November 2006, the Company's Board of Directors authorized the repurchase of up to \$2.0 million in common shares of the Company's outstanding common stock through its existing Stock Repurchase Plan effective through the end of November 2007. During 2007, the Company repurchased \$1.9 million, or 100,000 shares, of its common stock under this plan.

In August 2007, the Company's Board of Directors authorized the repurchase of up to 75,000 common shares of the Company's outstanding common stock through its existing Stock Repurchase Plan effective through the end of August 2008. The Company has repurchased 75,497 shares, or \$1.2 million, of its common stock under this plan. The Board of Directors ratified the purchase of 497 additional shares in March 2008.

In March 2008, the Company's Board of Directors authorized the repurchase of up to 100,000 common shares of the Company's outstanding common stock through its existing Stock Repurchase Plan effective through the end of March 2009. The Company has repurchased 15,500 shares, or \$199,000, of its common stock under this plan as of September 30, 2008. The Company repurchased 50,000 shares, or \$577,500, of its common stock under this plan on October 27, 2008.

Under the regulatory capital guidelines, financial institutions are currently required to maintain a total risk-based capital ratio of 8.0% or greater, with a Tier 1 risk-based capital ratio of 4.0% or greater. Tier 1 capital is generally defined as shareholders' equity and Trust Preferred Securities less all intangible assets and goodwill. Tier 1 capital at September 30, 2008 and December 31, 2007 includes \$20.0 million in trust preferred securities. The Company's Tier 1 capital ratio was 10.94% and 11.03% at September 30, 2008 and December 31, 2007, respectively. Total risk-based capital is defined as Tier 1 capital plus supplementary capital. Supplementary capital, or Tier 2 capital, consists of the Company's allowance for loan losses, not exceeding 1.25% of the Company's risk-weighted assets. Total risk-based capital ratio is therefore defined as the ratio of total capital (Tier 1 capital and Tier 2 capital) to risk-weighted assets. The Company's total risk-based capital ratio was 12.10% and 12.16% at September 30, 2008 and December 31, 2007, respectively. In addition to the Tier 1 and total risk-based capital requirements, financial institutions are also required to maintain a leverage ratio of Tier 1

capital to total average assets of 4.0% or greater. The Company's Tier 1 leverage capital ratio was 9.92% and 10.43% at September 30, 2008 and December 31, 2007, respectively.

The Bank's Tier 1 risk-based capital ratio was 9.91% and 9.80% at September 30, 2008 and December 31, 2007, respectively. The total risk-based capital ratio for the Bank was 11.08% and 10.93% at September 30, 2008 and December 31, 2007, respectively. The Bank's Tier 1 leverage capital ratio was 8.98% and 9.26% at September 30, 2008 and December 31, 2007, respectively.

A bank is considered to be "well capitalized" if it has a total risk-based capital ratio of 10.0 % or greater, a Tier 1 risk-based capital ratio of 6.0% or greater, and has a leverage ratio of 5.0% or greater. Based upon these guidelines, the Bank was considered to be "well capitalized" at September 30, 2008.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

There have been no material changes in the quantitative and qualitative disclosures about market risks as of September 30, 2008 from that presented in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2007.

Item Controls and Procedures

4T.

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

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

PART OTHER INFORMATION

II.

Item Legal Proceedings

1.

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

Item Risk Factors

1A.

There are no material changes from the risk factors as previously disclosed in the Company's Form 10-K in response to Item 1A. to Part I to Form 10-K, filed with Securities and Exchange Commission on March 12, 2008.

Item Unregistered Sales of Equity Securities and Use of

2. Proceeds

ISSUER PURCHASES OF EQUITY SECURITIES

| Period | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs |
|------------------------|---|------------------------------------|--|--|
| July 1 - 31, 2008 | - | \$ - | - | 84,500 |
| August 1 - 31, 2008 | - | - | - | 84,500 |
| September 1 - 30, 2008 | 2,510 | 11.59 | - | 84,500 |
| Total | 2,510 | \$ 11.59 | - | |

Item Defaults Upon Senior Securities

3.

Not applicable

Item Submission of Matters to a Vote of Security Holders

4.

No matter was submitted to a vote of the Company's shareholders during the quarter ended September 30, 2008.

Item Other Information

5.

Not applicable

Item Exhibits

6.

Exhibit Articles of Incorporation of Peoples
(3)(i) Bancorp of North Carolina, Inc.,
incorporated
by reference to Exhibit (3)(i) to the Form
8-A filed with the Securities and
Exchange Commission on September 2,
1999

Exhibit Amended and Restated Bylaws of Peoples
(3)(ii) Bancorp of North Carolina, Inc.,
incorporated by reference to Exhibit
(3)(ii) to the Form 10-Q filed with the
Securities and Exchange Commission on
November 7, 2007

Exhibit Specimen Stock Certificate, incorporated
(4) by reference to Exhibit (4) to the Form 8-
A filed with the Securities and Exchange
Commission on September 2, 1999

Exhibit (10)(a) Employment Agreement between Peoples Bank and Tony W. Wolfe incorporated by reference to Exhibit (10)(a) to the Form 10-K filed with the Securities and Exchange Commission on March 30, 2000

Exhibit (10)(b) Employment Agreement between Peoples Bank and Joseph F. Beaman, Jr. incorporated by reference to Exhibit (10)(b) to the Form 10-K filed with the Securities and Exchange Commission on March 30, 2000

Exhibit (10)(c) Employment Agreement between Peoples Bank and William D. Cable, Sr. incorporated by reference to Exhibit (10)(d) to the Form 10-K filed with the Securities and Exchange Commission on March 30, 2000

Exhibit (10)(d) Employment Agreement between Peoples Bank and Lance A. Sellers incorporated by reference to Exhibit (10)(e) to the Form 10-K filed with the Securities and Exchange Commission on March 30, 2000

Exhibit (10)(e) Peoples Bancorp of North Carolina, Inc. Omnibus Stock Ownership and Long Term Incentive Plan incorporated by reference to Exhibit (10)(f) to the Form 10-K filed with the Securities and Exchange Commission on March 30, 2000

Exhibit (10)(e)(i) Amendment No. 1 to the Peoples Bancorp of North Carolina, Inc. Omnibus Stock Ownership and Long Term Incentive Plan incorporated by reference to Exhibit (10)(e)(i) to the Form 10-K filed with the Securities and Exchange Commission on March 15, 2007

Exhibit (10)(f) Employment Agreement between Peoples Bank and A. Joseph Lampron incorporated by reference to Exhibit (10)(g) to the Form 10-K filed with the Securities and Exchange Commission on March 28, 2002

- Exhibit (10)(g) Peoples Bank Directors' and Officers' Deferral Plan, incorporated by reference to Exhibit (10)(h) to the Form 10-K filed with the Securities and Exchange Commission on March 28, 2002
- Exhibit (10)(h) Rabbi Trust for the Peoples Bank Directors' and Officers' Deferral Plan, incorporated by reference to Exhibit (10)(i) to the Form 10-K filed with the Securities and Exchange Commission on March 28, 2002
- Exhibit (10)(i) Description of Service Recognition Program maintained by Peoples Bank, incorporated by reference to Exhibit (10)(i) to the Form 10-K filed with the Securities and Exchange Commission on March 27, 2003
- Exhibit (10)(j) Capital Securities Purchase Agreement dated as of June 26, 2006, by and among Peoples Bancorp of North Carolina, Inc., PEBK Capital Trust II and Bear, Sterns Securities Corp. incorporated by reference to Exhibit (10)(j) to the Form 10-Q filed with the Securities and Exchange Commission on November 13, 2006
- Exhibit (10)(k) Amended and Restated Trust Agreement of PEBK Capital Trust II, dated as of June 28, 2006 incorporated by reference to Exhibit (10)(k) to the Form 10-Q filed with the Securities and Exchange Commission on November 13, 2006
- Exhibit (10)(l) Guarantee Agreement of Peoples Bancorp of North Carolina, Inc. dated as of June 28, 2006 incorporated by reference to Exhibit (10)(l) to the Form 10-Q filed with the Securities and Exchange Commission on November 13, 2006
- Exhibit (10)(m) Indenture, dated as of June 28, 2006, by and between Peoples Bancorp of North Carolina, Inc. and LaSalle Bank National Association, as Trustee, relating to Junior Subordinated Debt Securities Due September 15, 2036 incorporated by

reference to Exhibit (10)(m) to the Form
10-Q filed with Securities and
Exchange Commission on November 13,
2006

ExhibitCode of Business Conduct and Ethics of
(14) Peoples Bancorp of North Carolina, Inc.,
incorporated by reference to Exhibit (14)
to the Form 10-K filed with the
Securities and Exchange Commission on
March 25, 2005

Exhibit Certification of principal executive officer
(31)(a) pursuant to section 302 of the Sarbanes-
Oxley Act of 2002

Exhibit Certification of principal financial officer
(31)(b) pursuant to section 302 of the Sarbanes-
Oxley Act of 2002

Exhibit Certification Pursuant to 18 U.S.C.
(32) Section 1350, as adopted pursuant to
Section
906 of the Sarbanes-Oxley Act of 2002

SIGNATURES

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

Peoples Bancorp of North Carolina, Inc.

November 10, 2008
Date

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

November 10, 2008
Date

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

