FIRST MARINER BANCORP
Form 10-Q
November 16, 2012

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

FORM 10-Q

(Mark One)

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934.**

For the quarterly period ended September 30, 2012.

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934.**

For the transition period from to

Commission file number: 0-21815

FIRST MARINER BANCORP
(Exact name of registrant as specified in its charter)

Maryland		**52-1834860**
(State of Incorporation)		(I.R.S. Employer Identification Number)
1501 South Clinton Street, Baltimore, MD	**21224**	**410-342-2600**
(Address of principal executive offices)	(Zip Code)	(Telephone Number)

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 during the preceding 12 months (or for such shorter period that the registrant was required to file such report, and (2) has been subject to such filing requirements for the past 90 days.
Yes x No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No o (Not Applicable)

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

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

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

The number of shares of common stock outstanding as of November 9, 2012 is 18,860,482 shares.

EXPLANATORY NOTE

First Mariner Bancorp (the Company) was unable to meet the filing deadline of November 14, 2012 with respect to this Quarterly Report on Form 10-Q for the quarter ended September 30, 2012 (the Form 10-Q) due to Hurricane Sandy and its aftermath. The Company is relying on the Order Under Section 17A and Section 36 of the Securities Exchange Act of 1934 Granting Exemptions from Specified Provisions of the Exchange Act and Certain Rules Thereunder issued by the Securities Exchange Commission (the Commission) on November 14, 2012, pursuant to which a registrant subject to the reporting requirements of Exchange Act Section 13(a) or 15(d) is exempt from any requirement to file or furnish materials with the Commission under Exchange Act Sections 13(a), 13(d), 13(f), 13(g), 14(a), 14(c), 15(d) and 16(a) and certain other rules and regulations of the Commission, as applicable, for the period from and including October 29, 2012 to November 20, 2012, where certain conditions are satisfied. The Company was unable to file the Form 10-Q on a timely basis because the Company s EDGAR service provider, which is located in lower Manhattan, was severely impacted by Hurricane Sandy and was delayed in preparing the Form 10-Q, including the Interactive Data Files filed as an exhibit thereto. The Company was not advised of a delay in the preparation of the Form 10-Q, including the Interactive Data Files, until shortly before the filing deadline, at which point there was insufficient time to make alternative arrangements to meet the filing deadline.

FIRST MARINER BANCORP AND SUBSIDIARY
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CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

Some of our statements contained in, or incorporated by reference into, this Quarterly Report on Form 10-Q are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. We intend such forward-looking statements to be covered by the safe harbor provisions for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995 and are including this statement for purposes of invoking these safe harbor provisions. Forward-looking statements are not guarantees of performance or results. When we use words like may, plan, contemplate, anticipate, believe, intend, co expect, project, predict, estimate, target, could, is likely, should, would, will, and similar expressions, you should consider the forward-looking statements, although we may use other phrasing. These forward-looking statements involve risks and uncertainties and are based on our beliefs and assumptions and on the information available to us at the time that these disclosures were prepared. These forward-looking statements involve risks and uncertainties and may not be realized due to a variety of factors, including, but not limited to, the following:

- the strength of the United States economy in general, the strength of the local economies in which we conduct operations, and the effects of future economic conditions, including inflation, recession, and/or decreasing real estate values;
- geopolitical conditions, including acts or threats of terrorism, actions taken by the United States or other governments in response to acts or threats of terrorism and/or military conflicts, which could impact business and economic conditions in the United States and abroad;
- the effects of, and changes in, trade, monetary, and fiscal policies and laws, including interest rate policies of the Federal Reserve Board, inflation, interest rate, market, and monetary fluctuations;
- the risks of changes in interest rates on the level and composition of deposits, loan demand, and the values of loan collateral, securities, and interest sensitive assets and liabilities;
- the effect of changes in accounting policies and practices, as may be adopted from time-to-time by bank regulatory agencies, the Securities and Exchange Commission, the Financial Accounting Standards Board, or other accounting standards setters;
- adverse changes in the securities markets;
- the effects of competition from other commercial banks, thrifts, mortgage-banking firms, consumer finance companies, credit unions, securities brokerage firms, insurance companies, money market and other mutual funds, and other financial institutions operating in our market area and elsewhere, including institutions operating regionally, nationally, and internationally, together with competitors offering banking products and services by mail, telephone, and the Internet;
- costs and potential disruption or interruption of operations due to cyber security incidents;
- a decline in demand for our products and services;
- an inability to attract and retain deposits;
- the timely development of competitive new products and services and the acceptance of these products and services by new and existing customers;
- changes in consumer spending and savings habits;
- the effect of any mergers, acquisitions, or other transactions to which we or our subsidiary may from time to time be a party;
- our ability to effectively manage market risk, credit risk, and operational risk;
- unanticipated regulatory or judicial proceedings;
- the success and timing of our business strategies and our ability to effectively carry out our business and capital plans;

our ability to continue to operate as a going concern;

our ability to realize the benefits from our cost saving initiatives;

our ability to meet our interest payment obligations on our junior subordinated deferrable interest debentures upon expiration of the deferral period in 2013;

an ability to raise sufficient capital to comply with the requirements of our regulators and for continued support of operations;

the imposition of additional enforcement actions by bank regulatory authorities upon First Mariner Bank or First Mariner Bancorp;

our ability to successfully implement our plan to reduce First Mariner Bank s risk exposure to problem assets;

the failure of assumptions underlying the establishment of our allowance for loan losses that may prove to be materially incorrect or may not be borne out by subsequent events;

increased loan delinquencies and/or an escalation in problem assets and foreclosures;

a reduction in the value of the collateral for loans made by us, especially real estate, which, in turn would likely reduce our customers borrowing power and the value of assets and collateral associated with our existing loans;

a reduction in the value of certain assets held by us;

our ability to successfully implement our liquidity contingency plan and meet our liquidity needs;

the risks described in this Quarterly Report on Form 10-Q, our Quarterly Report on Form 10-Q for the six months ended June 30, 2012, our Quarterly Report on Form 10-Q for the three months ended March 31, 2012, and our Annual Report on Form 10-K as of and for the year ended December 31, 2011.

All written or oral forward-looking statements attributable to us are expressly qualified in their entirety by this Cautionary Note. Our actual results may differ significantly from those we discuss in these forward-looking statements. For other factors, risks, and uncertainties that could cause our actual results to differ materially from estimates and projections contained in these forward-looking statements, please read the Risk Factors in Item 1A of Part II of this Quarterly Report on Form 10-Q, our Quarterly Reports on Form 10-Q for the quarters ended June 30, 2012 and March 31, 2012 and in Item 1A of Part I of our Annual Report on Form 10-K as of and for the year ended December 31, 2011. Any forward-looking statement speaks only as of the date which such statement was made, and, except as required by law, we expressly disclaim any obligation or undertaking to disseminate any updates or revisions to any forward-looking statement to reflect events or circumstances after the date on which such statement is made or to reflect the occurrence of unanticipated events.

PART I FINANCIAL INFORMATION

Item 1 Financial Statements

First Mariner Bancorp and Subsidiary
Consolidated Statements of Financial Condition
(dollars in thousands, except per share data)

	September 30, 2012	December 31, 2011
	(unaudited)	
ASSETS		
Cash and due from banks	$ 78,897	$ 104,204
Federal funds sold and interest-bearing deposits	32,310	44,585
Securities available for sale (AFS), at fair value	45,334	22,682
Loans held for sale (LHFS), at fair value	371,554	182,992
Loans receivable	643,468	701,751
Allowance for loan losses	(12,096)	(13,801)
Loans, net	631,372	687,950
Real estate acquired through foreclosure	19,978	25,235
Restricted stock investments	6,829	7,085
Premises and equipment, net	37,534	38,278
Accrued interest receivable	4,015	4,025
Bank-owned life insurance (BOLI)	38,332	37,478
Prepaid expenses and other assets	27,879	24,503
Total assets	$ 1,294,034	$ 1,179,017
LIABILITIES AND STOCKHOLDERS DEFICIT		
Liabilities:		
Deposits:		
Noninterest-bearing	$ 99,372	$ 100,303
Interest-bearing	1,008,779	914,457
Total deposits	1,108,151	1,014,760
Short-term borrowings	47,261	47,981
Long-term borrowings	73,567	73,698
Junior subordinated deferrable interest debentures	52,068	52,068
Accrued expenses and other liabilities (of which, $115 and $18 are at fair value, respectively)	21,756	15,922
Total liabilities	1,302,803	1,204,429
Stockholders deficit:		
Common stock, $.05 par value; 75,000,000 shares authorized; 18,860,482 shares issued and outstanding at both September 30, 2012 and December 31, 2011	939	939
Additional paid-in capital	80,006	80,125
Retained deficit	(88,036)	(103,454)
Accumulated other comprehensive loss	(1,678)	(3,022)
Total stockholders deficit	(8,769)	(25,412)

Total liabilities and stockholders deficit	$ 1,294,034	$ 1,179,017

See accompanying notes to consolidated financial statements

First Mariner Bancorp and Subsidiary
Consolidated Statements of Operations
(dollars in thousands except per share data)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
		(unaudited)		
Interest income:				
Loans	$ 11,567	$ 11,222	$ 33,644	$ 33,867
Investments and other earning assets	352	455	1,063	1,651
Total interest income	11,919	11,677	34,707	35,518
Interest expense:				
Deposits	2,898	3,625	8,857	12,217
Short-term borrowings	35	61	99	232
Long-term borrowings	927	852	2,780	2,476
Total interest expense	3,860	4,538	11,736	14,925
Net interest income	8,059	7,139	22,971	20,593
Provision for loan losses		5,000	572	11,580
Net interest income after provision for loan losses	8,059	2,139	22,399	9,013
Noninterest income:				
Total other-than-temporary impairment (OTTI) charges		(299)	175	(327)
Less: Portion included in other comprehensive income (pre-tax)		(382)	(635)	(491)
Net OTTI charges on AFS securities		(681)	(460)	(818)
Mortgage-banking revenue	15,384	4,609	35,450	7,942
ATM fees	649	755	2,067	2,314
Service fees on deposits	623	717	1,927	2,194
Gain on sale of AFS securities		638		781
(Loss) gain on sales and disposals of premises and equipment and other assets	(949)	2	(1,271)	4
Commissions on sales of nondeposit investment products	62	75	211	347
Income from BOLI	273	316	853	984
Other	238	1,289	717	1,779
Total noninterest income	16,280	7,720	39,494	15,527
Noninterest expense:				
Salaries and employee benefits	6,107	5,876	17,438	18,003
Occupancy	1,835	2,202	6,343	6,407
Furniture, fixtures, and equipment	332	426	1,018	1,357
Professional services	973	1,259	2,085	3,742
Advertising	189	219	609	470
Data processing	403	393	1,237	1,237
ATM servicing expenses	225	217	678	655
Write-downs, losses, and costs of real estate acquired through foreclosure	1,325	3,218	3,539	6,635
Federal Deposit Insurance Corporation (FDIC) insurance premiums	1,009	878	3,131	3,390
Service and maintenance	644	594	1,799	1,872
Corporate Insurance	695	388	1,571	1,069
Consulting fees	395	377	1,319	1,042

Loan collection expenses	101	329	290	608
Other	2,180	1,443	5,623	4,322
Total noninterest expense	16,413	17,819	46,680	50,809
Net income (loss) before income taxes	7,926	(7,960)	15,213	(26,269)
Income tax benefit			(205)	
Net income (loss)	$ 7,926	$ (7,960)	$ 15,418	$ (26,269)
Net income (loss) per common share - basic and diluted	$ 0.42	$ (0.42)	$ 0.82	$ (1.41)

See accompanying notes to consolidated financial statements.

First Mariner Bancorp and Subsidiary
Consolidated Statements of Comprehensive Income (Loss)
(dollars in thousands)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	**2011**	**2012**	**2011**
		(unaudited)		
Net income (loss)	$ 7,926	$ (7,960)	$ 15,418	$ (26,269)
Other comprehensive income items:				
Unrealized holding gains (losses) on securities arising during the period (net of tax expense (benefit) of $293, $(219), $724, and $309, respectively)	433	(324)	1,070	457
Reclassification adjustment for net losses on securities (net of tax benefit of $0, $17, $186, and $15, respectively) included in net income (loss)		26	274	22
Total other comprehensive income (loss)	433	(298)	1,344	479
Total comprehensive income (loss)	$ 8,359	$ (8,258)	$ 16,762	$ (25,790)

See accompanying notes to consolidated financial statements.

First Mariner Bancorp and Subsidiary
Consolidated Statements of Changes in Stockholders (Deficit) Equity
(dollars in thousands except per share data)

Nine Months Ended September 30, 2012

(unaudited)

	Number of Shares of Common Stock	Common Stock	Additional Paid-in Capital	Retained Deficit	Accumulated Other Comprehensive Loss	Total Stockholders Deficit
Balance at December 31, 2011	18,860,482	$ 939	$ 80,125	$ (103,454)	$ (3,022)	$ (25,412)
Net income				15,418		15,418
Costs of common stock issued, net			(22)			(22)
Change in fair value of warrants			(97)			(97)
Changes in unrealized gains on securities, net of taxes					1,344	1,344
Balance at September 30, 2012	18,860,482	$ 939	$ 80,006	$ (88,036)	$ (1,678)	$ (8,769)

Nine Months Ended September 30, 2011

(unaudited)

	Number of Shares of Common Stock	Common Stock	Additional Paid-in Capital	Retained Deficit	Accumulated Other Comprehensive Loss	Total Stockholders Equity (Deficit)
Balance at December 31, 2010	18,050,117	$ 902	$ 79,667	$ (73,210)	$ (3,613)	$ 3,746
Net loss				(26,269)		(26,269)
Common stock issued, net of costs	810,365	37	341			378
Stock-based compensation expense			5			5
Change in fair value of warrants			89			89
Changes in unrealized gains on securities, net of taxes					479	479
Balance at September 30, 2011	18,860,482	$ 939	$ 80,102	$ (99,479)	$ (3,134)	$ (21,572)

See accompanying notes to consolidated financial statements.

First Mariner Bancorp and Subsidiary
Consolidated Statements of Cash Flows
(dollars in thousands)

	Nine Months Ended September 30,	
	2012	2011
	(unaudited)	
Cash flows from operating activities:		
Net income (loss)	$ 15,418	$ (26,269)
Adjustments to reconcile net income (loss) to net cash from operating activities:		
Depreciation and amortization	2,043	2,472
Amortization of unearned loan fees and costs, net	496	283
Amortization of discounts on mortgage-backed securities, net	6	29
Origination fees and gains on sale of mortgage loans	(33,615)	(6,750)
Net OTTI charges on AFS securities	460	818
Gain on sale of AFS securities		(781)
Loss (gain) on disposition and sale of premises and equipment and other assets	1,271	(4)
Decrease (increase) in accrued interest receivable	10	(4)
Provision for loan losses	572	11,580
Write-downs and losses on sale of real estate acquired through foreclosure	1,818	5,704
Increase in cash surrender value of BOLI	(853)	(984)
Originations of mortgage LHFS	(1,773,267)	(691,831)
Proceeds from sales of mortgage LHFS	1,617,977	710,702
Net increase in accrued expenses and other liabilities	5,736	4,318
Net increase in prepaids and other assets	(4,283)	(11,710)
Net cash used in operating activities	(166,211)	(2,427)
Cash flows from investing activities:		
Loan principal repayments, net	49,315	49,542
Repurchase of loans previously sold	(827)	(435)
Sale of restricted stock investments	256	126
Purchases of premises and equipment	(2,571)	(327)
Activity in AFS securities:		
Maturities/calls/repayments	9,217	16,206
Sales		49,511
Purchases	(29,001)	(59,799)
Additional funds disbursed on real estate acquired through foreclosure		(1,755)
Proceeds from sales of real estate acquired through foreclosure	9,722	8,570
Net cash provided investing activities	36,111	61,639
Cash flows from financing activities:		
Net increase (decrease) in deposits	93,392	(90,010)
Net decrease in other borrowed funds	(852)	(479)
Net costs of stock issuance	(22)	(20)
Net cash provided by (used in) financing activities	92,518	(90,509)
Decrease in cash and cash equivalents	(37,582)	(31,297)
Cash and cash equivalents at beginning of period	148,789	217,961
Cash and cash equivalents at end of period	$ 111,207	$ 186,664

Supplemental information:		
Interest paid on deposits and borrowed funds	$ 10,522	$ 13,997
Real estate acquired in satisfaction of loans	$ 6,283	$ 16,073
Transfers of LHFS to loan portfolio	$ 342	$ 2,031

See accompanying notes to consolidated financial statements

First Mariner Bancorp and Subsidiary
Notes to Consolidated Financial Statements
(Information as of and for the three and nine months ended September 30, 2012 and 2011 is unaudited)

(1) Summary of Significant Accounting Policies
Basis of Presentation

The accompanying consolidated financial statements for First Mariner Bancorp have been prepared in accordance with the instructions for Form 10-Q and, therefore, do not include all information and notes necessary for a full presentation of financial condition, results of operations, and cash flows in conformity with accounting principles generally accepted in the United States of America (U.S.) (GAAP). The consolidated financial statements should be read in conjunction with the audited financial statements included in First Mariner Bancorp s Annual Report on Form 10-K as of and for the year ended December 31, 2011. When used in these notes, the terms the Company, we, us, and our refer to First Mariner Bancorp and, unless the context requires otherwise, its consolidated subsidiary.

The consolidated financial statements include the accounts of First Mariner and its wholly owned subsidiary, First Mariner Bank (the Bank). All significant intercompany accounts and transactions have been eliminated in consolidation. Events occurring after the date of the financial statements were considered in the preparation of the financial statements. Certain reclassifications have been made to amounts previously reported to conform to classifications made in 2012.

The consolidated financial statements as of and for the three and nine months ended September 30, 2012 and 2011 are unaudited but include all adjustments, consisting only of normal recurring adjustments, which we consider necessary for a fair presentation of financial position and results of operations for those periods. The results of operations for the three and nine months ended September 30, 2012 are not necessarily indicative of the results that will be achieved for the entire year or any future interim period.

The preparation of the financial statements in conformity with GAAP requires management to make estimates and judgments that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

(2) Going Concern Consideration

Due to the conditions and events discussed later in Note 5, there is substantial doubt regarding our ability to continue as a going concern. Management is taking various steps designed to improve the Bank s capital position. The Bank has developed a written alternative capital plan designed to improve the Bank s capital ratios. Such plan is dependent upon a capital infusion to meet the capital requirements of the various regulatory agreements (see Note 5 for more information on the agreements). The Company continues to work with its advisors in an attempt to improve capital ratios.

The consolidated financial statements presented above and the accompanying Notes have been prepared on a going concern basis, which contemplates the realization of assets and the discharge of liabilities in the normal course of business for the foreseeable future, and does not include any adjustment to reflect the possible future effects on the recoverability and classification of assets, or the amounts and classification of liabilities that may result from the outcome of any extraordinary regulatory action, which would affect our ability to continue as a going concern.

(3) Securities

The composition of our securities portfolio (all AFS) is as follows:

	September 30, 2012			
	Amortized Cost	**Unrealized Gains**	**Unrealized Losses**	**Estimated Fair Value**
	(dollars in thousands)			
Mortgage-backed securities	$ 5,341	$ 215	$	$ 5,556
Trust preferred securities	11,264	96	2,279	9,081
U.S. government agency notes	25,349	110	1	25,458
U.S. Treasury securities	3,037	1		3,038
Equity securities - banks	1,288	134	18	1,404
Equity securities - mutual funds	750	47		797
	$ 47,029	$ 603	$ 2,298	$ 45,334

	December 31, 2011			
	Amortized Cost	**Unrealized Gains**	**Unrealized Losses**	**Estimated Fair Value**
	(dollars in thousands)			
Mortgage-backed securities	$ 1,834	$ 125	$	$ 1,959
Trust preferred securities	13,420	103	3,255	10,268
U.S. government agency notes	8,507	11		8,518
U.S. Treasury securities	1,004			1,004
Equity securities - banks	189	6	44	151
Equity securities - mutual funds	750	32		782
	$ 25,704	$ 277	$ 3,299	$ 22,682

Contractual maturities of debt securities at September 30, 2012 are shown below. Actual maturities may differ from contractual maturities because borrowers have the right to call or prepay obligations with or without call or prepayment penalties.

	Amortized Cost	**Estimated Fair Value**
	(dollars in thousands)	
Due in one year or less	$ 8,004	$ 8,024
Due after one year through five years	20,382	20,471

Due after five years through ten years	1,020	1,008
Due after ten years	10,244	8,074
Mortgage-backed securities	5,341	5,556
	$ 44,991	$ 43,133

The following tables show the level of our gross unrealized losses and the fair value of the associated securities by type and maturity for AFS securities:

	September 30, 2012					
	Less than 12 months		12 months or more		Total	
	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses
	(dollars in thousands)					
Trust preferred securities	$	$	$ 4,910	$ 2,279	$ 4,910	$ 2,279
U.S. government agency notes	3,025	1			3,025	1
Equity securities - banks			107	18	107	18
	$ 3,025	$ 1	$ 5,017	$ 2,297	$ 8,042	$ 2,298

	December 31, 2011					
	Less than 12 months		12 months or more		Total	
	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses
	(dollars in thousands)					
Trust preferred securities	$ 1,967	$ 66	$ 4,542	$ 3,189	$ 6,509	$ 3,255
Equity securities - banks			63	44	63	44
	$ 1,967	$ 66	$ 4,605	$ 3,233	$ 6,572	$ 3,299

The trust preferred securities that we hold in our securities portfolio are issued by other banks, bank holding companies, and insurance companies. Certain of these securities have experienced declines in value since acquisition. These declines have occurred due to changes in the market which has limited the demand for these securities and reduced their liquidity. We consider the decline in value for four of the pooled trust preferred securities to be other than temporary and recorded the credit-related portion of the impairment as net OTTI of $460,000 for the nine months ended September 30, 2012. We did not record any additional OTTI during the three months ended September 30, 2012. We recorded net OTTI of $681,000 and $818,000 for the three and nine months ended September 30, 2011, respectively. See additional information on the pooled trust preferred securities in Note 8.

The following shows the activity in OTTI related to credit losses for the three and nine months ended September 30:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	(dollars in thousands)			
Balance at beginning of period	$ 9,190	$ 8,029	$ 8,730	$ 7,892
Additional OTTI taken for credit losses		681	460	818
Balance at end of period	$ 9,190	$ 8,710	$ 9,190	$ 8,710

All of the remaining securities that are impaired are so due to declines in fair values resulting from changes in interest rates or increased credit/liquidity spreads since the time they were purchased. We have the intent to hold these debt securities to maturity, and, for debt and equity securities in a loss position, for the foreseeable future and do not intend, nor do we believe it is more likely than not, that we will be required to sell the securities before anticipated recovery. We expect these securities will be repaid in full, with no losses realized. As such, management considers the impairments to be temporary.

At September 30, 2012, we held securities with an aggregate carrying value (fair value) of $40.1 million that we have pledged as collateral for certain mortgage-banking and hedging activities, borrowings, government deposits, and customer deposits.

(4) Loans Receivable and Allowance for Loan Losses

Loans receivable are summarized as follows:

	September 30, 2012	December 31, 2011
	(dollars in thousands)	
Commercial	$ 45,632	$ 47,518
Commercial mortgage	296,353	331,943
Commercial construction	48,351	54,433
Consumer construction	19,071	16,456
Residential mortgage	112,811	121,071
Consumer	120,251	129,227
Total loans	642,469	700,648
Unearned loan fees, net	999	1,103
	$ 643,468	$ 701,751

Included in consumer loan totals in the above table are overdrawn commercial and retail checking accounts totaling $171,000 as of September 30, 2012 and $184,000 as of December 31, 2011.

Transferred Loans

In accordance with the Financial Accounting Standards Board (FASB) guidance on mortgage-banking activities, any loan which is originally originated for sale into the secondary market and which we subsequently elect to transfer into the Company s loan portfolio is valued at fair value at the time of the transfer with any decline in value recorded as a charge against earnings.

Information on the activity in transferred loans and related accretable yield is as follows for the three months ended September 30:

	Loan Balance		Accretable Yield		Total	
	2012	2011	2012	2011	2012	2011
			(dollars in thousands)			
Beginning balance	$ 10,873	$ 26,783	$ 36	$ 110	$ 10,837	$ 26,673
Loans transferred		1,053				1,053
Charge-offs	(781)		(4)	(10)	(777)	10
Payments/accretion	(1,625)	(10)	(8)	(10)	(1,617)	
Ending balance	$ 8,467	$ 27,826	$ 24	$ 90	$ 8,443	$ 27,736

Information on the activity in transferred loans and related accretable yield is as follows for the nine months ended September 30:

Loan Balance	Accretable Yield	Total

	2012	2011	2012	2011	2012	2011
			(dollars in thousands)			
Beginning balance	$ 14,008	$ 26,219	$ 266	$ 178	$ 13,742	$ 26,041
Loans transferred	342	2,031			342	2,031
Loans moved to real estate acquired through foreclosure		(83)				(83)
Charge-offs	(1,066)	(302)	(18)	(16)	(1,048)	(286)
Payments/accretion	(4,817)	(39)	(224)	(72)	(4,593)	33
Ending balance	$ 8,467	$ 27,826	$ 24	$ 90	$ 8,443	$ 27,736

At September 30, 2012, we had pledged loans with a carrying value of $111.5 million as collateral for Federal Home Loan Bank (FHLB) advances.

Credit Quality

Management has an established methodology to determine the adequacy of the allowance for loan losses that assesses the risks and losses inherent in the loan portfolio. For purposes of determining the allowance for loan losses, we have segmented our loan portfolio by product type. Our portfolio loan segments are commercial, commercial mortgage, commercial construction, consumer construction, residential mortgage, and consumer. We have looked at all segments to determine if subcategorization into classes is warranted based upon our credit review methodology. We have divided consumer loans into two classes, (1) home equity and second mortgage loans and (2) other consumer loans.

To establish the allowance for loan losses, loans are pooled by portfolio class and an historical loss percentage is applied to each class. The historical loss percentage is based upon a rolling 24 month history. This rolling history is utilized so that we have the most current and relevant charge-off trend data. These charge-offs are segregated by loan segment and compared to their respective loan segment average balances for the same period in order to calculate the charge-off percentage. That percentage is then applied to the current period loan balances to determine the required reserve. That calculation determines the required allowance for loan loss level. We then apply additional loss multipliers to the different segments of loans to reflect various environmental factors. This amount is considered our unallocated reserve. For individually evaluated loans (impaired loans), we do additional analyses to determine the impairment. In general, this impairment is included as part of the allocated allowance for loan losses for modified loans and is charged off for all other impaired loans. These loss estimates are performed under multiple economic scenarios to establish a range of potential outcomes for each criterion. Management applies judgment to develop its own view of loss probability within that range, using external and internal parameters with the objective of establishing an allowance for loss inherent within these portfolios as of the reporting date.

The following table presents by portfolio segment, the changes in the allowance for loan losses, and the recorded investment in loans:

	Three months ended September 30, 2012							
	Commercial	Commercial Mortgage	Commercial Construction	Consumer Construction	Residential Mortgage	Consumer	Unallocated	Total
				(dollars in thousands)				
Beginning Balance	$ 2,897	$ 1,562	$ 1,678	$ 130	$ 1,504	$ 2,250	$ 3,501	$ 13,522
Charge-offs		(253)	(206)		(365)	(638)		(1,462)
Recoveries					5	31		36
Net charge-offs		(253)	(206)		(360)	(607)		(1,426)
(Reversal of) provision for loan losses	(901)	299	(992)	91	434	391	678	
Ending Balance	$ 1,996	$ 1,608	$ 480	$ 221	$ 1,578	$ 2,034	$ 4,179	$ 12,096

	Nine months ended September 30, 2012							
	Commercial	Commercial Mortgage	Commercial Construction	Consumer Construction	Residential Mortgage	Consumer	Unallocated	Total
				(dollars in thousands)				
Beginning Balance	$ 2,768	$ 2,011	$ 1,809	$ 156	$ 2,711	$ 2,632	$ 1,714	$ 13,801
Charge-offs	(187)	(573)	(353)	(7)	(879)	(1,576)		(3,575)
Recoveries		612	52		425	209		1,298
Net (charge-offs) recoveries	(187)	39	(301)	(7)	(454)	(1,367)		(2,277)
(Reversal of) provision for loan losses	(585)	(442)	(1,028)	72	(679)	769	2,465	572
Ending Balance	$ 1,996	$ 1,608	$ 480	$ 221	$ 1,578	$ 2,034	$ 4,179	$ 12,096
Ending balance - individually evaluated for impairment	$ 149	$ 24	$	$	$ 202	$	$	$ 375
Ending balance - collectively evaluated for impairment	1,847	1,584	480	221	1,376	2,034	4,179	11,721
	$ 1,996	$ 1,608	$ 480	$ 221	$ 1,578	$ 2,034	$ 4,179	$ 12,096
Ending loan balance - individually	$ 9,872	$ 32,810	$ 11,652	$ 655	$ 17,740	$ 936		$ 73,665

evaluated for impairment							
Ending loan balance - collectively evaluated for impairment	35,845	263,464	36,667	18,231	95,075	120,521	569,803
	$ 45,717	$ 296,274	$ 48,319	$ 18,886	$ 112,815	$ 121,457	$ 643,468

	Three months ended September 30, 2011							
	Commercial	Commercial Mortgage	Commercial Construction	Consumer Construction	Residential Mortgage	Consumer	Unallocated	Total
				(dollars in thousands)				
Beginning Balance	$ 233	$ 2,586	$ 1,782	$ 360	$ 2,895	$ 3,089	$ 3,170	$ 14,115
Charge-offs	(2,367)	(1,325)	(131)		(670)	(590)		(5,083)
Recoveries			24		23	33		80
Net charge-offs	(2,367)	(1,325)	(107)		(647)	(557)		(5,003)
Provision for (reversal of) loan losses	4,823	605	(7)	(125)	976	92	(1,364)	5,000
Ending Balance	$ 2,689	$ 1,866	$ 1,668	$ 235	$ 3,224	$ 2,624	$ 1,806	$ 14,112

	Nine months ended September 30, 2011							
	Commercial	Commercial Mortgage	Commercial Construction	Consumer Construction	Residential Mortgage	Consumer	Unallocated	Total
				(dollars in thousands)				
Beginning Balance	$ 291	$ 2,542	$ 2,053	$ 817	$ 3,032	$ 2,417	$ 2,963	$ 14,115
Charge-offs	(5,240)	(1,834)	(728)	(24)	(2,209)	(2,021)		(12,056)
Recoveries		168	24		37	244		473
Net charge-offs	(5,240)	(1,666)	(704)	(24)	(2,172)	(1,777)		(11,583)
Provision for (reversal of) loan losses	7,638	990	319	(558)	2,364	1,984	(1,157)	11,580
Ending Balance	$ 2,689	$ 1,866	$ 1,668	$ 235	$ 3,224	$ 2,624	$ 1,806	$ 14,112
Ending balance - individually evaluated for impairment	$ 4	$ 89	$	$ 1	$ 352	$ 4	$	$ 450
Ending balance - collectively evaluated for impairment	2,685	1,777	1,668	234	2,872	2,620	1,806	13,662
	$ 2,689	$ 1,866	$ 1,668	$ 235	$ 3,224	$ 2,624	$ 1,806	$ 14,112
Ending loan balance - individually evaluated for	$ 4,400	$ 24,302	$ 11,701	$ 757	$ 19,742	$ 1,595		$ 62,497

impairment							
Ending loan balance - collectively evaluated for impairment	58,375	310,804	42,375	20,836	104,836	136,949	674,175
	$ 62,775	$ 335,106	$ 54,076	$ 21,593	$ 124,578	$ 138,544	$ 736,672

We use creditworthiness categories to grade commercial loans. Our internal grading system is based on experiences with similarly graded loans. Category ratings are reviewed each quarter. Our internal risk ratings are as follows:

Superior Credit Quality (RR1) This category includes credits that are secured by up to 95% advance against cash balances, municipal or corporate bonds carrying an A rating or better (subject to maturity), U.S. Government securities (subject to maturity), and fully marketable securities of companies with an A or better debt rating. In addition, the borrower must have a reasonable financial condition evidenced by complete financial statements.

High Credit Quality (RR2) This category includes credits that are secured by up to 70% advance against municipal or corporate bonds carrying an A rating or better, U.S. Government securities, and marketable securities of companies with an A or better debt rating. For individual credits, the credit must be secured by any of the aforementioned items or first deed of trust on residential owner-occupied property with a loan-to-value (LTV) ratio of 80% or less and adequate cash flow to service the debt. Permanent real estate loans on fully leased properties with A-rated tenants and a 70% or less LTV ratio with income coverage of 1.25 times or higher may qualify for this rating, with confirmation of tenants financial condition. No commercial construction loans may carry this rating at inception. At September 30, 2012 and December 31, 2011, none of our loans carried this risk rating.

Above Average Credit Quality (RR3) This category includes business loans to publicly traded companies with a B rating or better, commercial construction loans with a contingent-free take-out or substantial pre-leasing (75% or more of leasable space) with a LTV ratio of 70% or less, residential construction loans with pre-sold units and a LTV ratio of 70% or less as long as sales are on a noncontingent basis and the overall project is progressing on schedule as originally determined, loans to individuals with liquid assets and strong net worth and the additional ability to service the debt from sources unrelated to the purpose of the credit extension, and monitored credits to borrowers of sound financial condition with approved advance rates providing adequate margin so that collateral can be easily liquidated within 90 days or less.

Average/Satisfactory Credit Quality (RR4) In general, this category includes small-to-medium sized companies with satisfactory financial condition, cash flow, profitability, and balance sheet and income statement ratios, term loans and revolving credits with annual clean-up requirements, the majority of retail commercial credits, loans to partnerships or small businesses, most wholesale sales finance lines, wholesale distributors whose capital position and profitability are at Risk Management Association averages, and loans to individuals with acceptable financial condition and sufficient net cash flow to service the debt as long as the source of repayment is identifiable and sufficient to liquidate the debt within an acceptable period of time and a secondary source of repayment is evident.

Acceptable With Care (RR5) This category includes secured loans to small or medium sized companies which have suffered a financial setback where a convincing plan for correction demonstrates the deficiency is temporary in nature, loans with debt service coverage ratios below or LTV ratios above policy guidelines, most construction and development loans, permanent loans underwritten based on pro forma rents as opposed to historical or actual rents, real estate loans where the project is moderately off the original projections as to cost estimates or absorption, and loans where the interest reserve is no longer adequate, but the customer or guarantor has a proven ability to carry the interest expense out of pocket for an extended time period without undue financial strain. These credits require additional attention by the account officer and/or loan administration.

Watch Credits (RR6) This category includes loans to borrowers who have experienced a temporary setback or deterioration in financial condition that should correct itself during the next twelve months, companies whose financial condition has been marginally acceptable for a period of time and prospects for significant improvement are limited, loans to individuals with marginal financial condition, and most credits for start-up operations. Also included in this category are real estate loans where the project is moderately off original projections, interest reserve may be depleted, with the borrower or guarantor having a questionable or unproved ability to pay interest out of pocket. Such loans may have modest cost overruns that will cause a shortage in the budget, raising question as to how the project will be completed. These loans may have a good collateral position, additional collateral, or strong guarantors to mitigate the risk. These credits are considered marginally acceptable, and greater than usual attention is warranted by the account officer and/or loan operations.

Special Mention (RR7) special mention credits are characterized as adequately covered by collateral (if any) and/or the paying capacity of the borrower, but are subject to one or more deteriorating trends. These credits constitute an undue and unwarranted credit risk, but not to the point of justifying a classification of substandard. These credits have potential weaknesses which, if not examined and corrected, may weaken the asset or inadequately protect the Bank s credit position at some future date. This category should not be used to list assets that bear risks usually associated with the particular type of financing. Assets with this rating may have the potential for significant weakness. Loans where weaknesses are evident and significant must be considered for more serious criticism. Examples of credits carried in special mention may include the following:

Loans which are fully covered by collateral and cash flow, but where margins are inadequate;

Loans to borrowers with a strong capital base, who are experiencing modest losses;

Loans to borrowers with very strong cash flows, but experiencing modest losses;

Credits that are subject to manageable, but excessive, leverage;

Credits with material collateral documentation exceptions, but which appear to be strong credits. If the documentation exception results in an unperfected/under secured collateral position, the credit may be risk rated as if it were under secured until such time as the exception is corrected;

Credits to customers who have not provided the Bank with current or satisfactory financial data (unless the credit is secured by liquid marketable collateral or guaranteed by financially sound parties);

Credits that the account officer may be unable to supervise properly because of a lack of expertise or lack of control over the collateral and/or its condition;

Loans with deficient documentation or other deviations from prudent lending practices; and

Loans with strong guarantors and/or secondary sources of cash flow are the support for repayment.

Substandard (RR8) Substandard loans are inadequately protected by the current sound worth and paying capacity of the obligor or the collateral pledged, if any. Loans so classified have a well-defined weakness or weaknesses, which jeopardize the orderly liquidation of the debt. They are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected. The borrower s financial condition indicates an inability to repay, even if restructured. Prospects for improvement in the borrower s financial condition are poor. Primary repayment source appears to be shifting from cash flow to liquidation of collateral. Examples of substandard credits may include the following:

Credits adequately covered by collateral value, where repayment is dependent upon the sale of nonliquid collateral, nontrading assets, or from guarantors;

Loans secured by collateral greater than the amount of the credit, but where cash flow is inadequate to amortize the debt over a reasonable period of time;

Credits with negative financial trends coupled with material collateral documentation deficiencies or where there is a high potential for loss of principal;

Unsecured loans to borrowers whose financial condition does not warrant unsecured advances;

Credits where the borrower is in bankruptcy or the work out effort is proceeding toward legal remedies including foreclosure; and

All nonaccrual loans.

Doubtful (RR9) Doubtful classifications have all the weaknesses inherent in those classified substandard with the added characteristic that the weaknesses make collection or liquidation in full on the basis of currently known facts, conditions, and values highly questionable and improbable. A doubtful classification may be appropriate in cases where significant risk exposures are perceived, but loss cannot be determined because of specific, reasonable, and pending factors which may strengthen and work to the advantage of the credit in the near term. Account officers attempt to identify any principal loss in the credit, where possible, thereby limiting the excessive use of the doubtful classification. The classification is a deferral of the estimated loss until its more exact status may be determined. Pending factors include proposed mergers, acquisition or liquidation procedures, new capital injection, perfecting liens on additional collateral, and refinancing plans. At September 30, 2012 and December 31, 2011, none of our loans carried this risk rating.

Loss (RR10) Losses must be taken as soon as they are realized. In some instances and on a temporary basis, a portion of a loan may receive this rating (split rating) when the actual loss cannot be currently identified. In these instances, additional facts or information is necessary to determine the final amount to be charged against the loan loss reserve. When applied for these purposes, this risk rating may be used for a period not to exceed three months. Subsequent to the identification of this split rating, the remaining balance will be risk rated substandard. This category includes advances in excess of calculated current fair value which are considered uncollectible and do not warrant continuance as bankable assets. This classification does not mean that the loan has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may occur in the future. Credits to distressed borrowers lacking an identifiable and realistic source of repayment are generally charged-off. Loans where repayment is dependent upon events that are not predictable in terms of result or timing (such as protracted litigation) are generally charged-off. At September 30, 2012 and December 31, 2011, none of our loans carried this risk rating.

The following table shows the credit quality breakdown of our commercial loan portfolio by class as of September 30, 2012 and December 31, 2011:

	Commercial		Commercial Mortgage		Commercial Construction		Consumer Construction		Total	
	2012	2011	2012	2011	2012	2011	2012	2011	2012	2011
	(dollars in thousands)									
RR8	$ 2,810	$ 5,672	$ 27,835	$ 26,677	$ 10,857	$ 17,105	$	$	$ 41,502	$ 49,454
RR7	7,370	9,051	20,371	17,065	9,862	9,152			37,603	35,268
RR6	10,039	10,208	49,603	39,722	15,853	13,132			75,495	63,062
RR5	17,249	19,825	107,472	122,880	10,836	12,013		136	135,557	154,854
RR4	8,225	7,074	87,788	117,088	911	2,947	18,886	16,144	115,810	143,253
RR3		1,000	3,205	3,098					3,205	4,098
RR1	24	12							24	12
	$ 45,717	$ 52,842	$ 296,274	$ 326,530	$ 48,319	$ 54,349	$ 18,886	$ 16,280	$ 409,196	$ 450,001

We do not individually grade residential mortgage or consumer loans. Such loans are classified as performing or nonperforming. Loan performance is reviewed each quarter. The following table shows performing and nonperforming (nonaccrual) residential mortgage and consumer loans by class as of September 30, 2012 and December 31, 2011:

	Residential Mortgage		Home Equity & 2nd Mortgage		Other Consumer		Total	
	2012	2011	2012	2011	2012	2011	2012	2011
	(dollars in thousands)							
Nonaccrual loans	$ 7,732	$ 7,585	$ 920	$ 905	$ 16	$	$ 8,668	$ 8,490
Performing loans	105,083	113,534	102,309	108,539	18,212	21,187	225,604	243,260
	$ 112,815	$ 121,119	$ 103,229	$ 109,444	$ 18,228	$ 21,187	$ 234,272	$ 251,750

The following tables show the aging of our loans receivable by class. Also included are loans that are 90 days or more past due as to interest and principal and still accruing because they are well-secured and in the process of collection.

September 30, 2012:

	30-59 Days Past Due	60-89 Days Past Due	90 Days or More Past Due	Total Past Due	Current	Total Loans	90 Days or More and Accruing
	(dollars in thousands)						
Commercial	$	$	$ 2,156	$ 2,156	$ 43,561	$ 45,717	$
Commercial mortgage	4,268		20,601	24,869	271,405	296,274	
Commercial construction	95		4,580	4,675	43,644	48,319	
Consumer construction	192		655	847	18,039	18,886	
Residential mortgage	3,455	1,001	7,732	12,188	100,627	112,815	
Home equity and 2nd mortgage	2,578	11	920	3,509	99,720	103,229	
Other consumer	70	2	16	88	18,140	18,228	
	$ 10,658	$ 1,014	$ 36,660	$ 48,332	$ 595,136	$ 643,468	$

December 31, 2011:

	30-59 Days Past Due	60-89 Days Past Due	90 Days or More Past Due	Total Past Due	Current	Total Loans	90 Days or More and Accruing
				(dollars in thousands)			
Commercial	$ 477	$	$ 4,596	$ 5,073	$ 47,769	$ 52,842	$ 30
Commercial mortgage	12,630	4,116	18,227	34,973	291,557	326,530	1,272
Commercial construction		5,170	7,981	13,151	41,198	54,349	2,032
Consumer construction	306		956	1,262	15,018	16,280	238
Residential mortgage	6,266		10,085	16,351	104,768	121,119	2,500
Home equity and 2nd mortgage	3,203	251	1,142	4,596	104,848	109,444	237
Other consumer	283	137	7	427	20,760	21,187	7
	$ 23,165	$ 9,674	$ 42,994	$ 75,833	$ 625,918	$ 701,751	$ 6,316

Impaired loans include nonaccrual loans and troubled debt restructures (TDR or TDRs). The following tables show the breakout of impaired loans by class:

	September 30, 2012			Nine Months Ended September 30, 2012			Nine Months Ended September 30, 2011		
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized	Charge-Offs	Average Recorded Investment	Interest Income Recognized	Charge-Offs
	(dollars in thousands)								
With no related allowance:									
Commercial	$ 2,589	$ 2,589	$	$ 3,895	$ 38	$ 187	$ 2,197	$ 7	$ 5,240
Commercial mortgage	$ 30,354	$ 30,354	$	$ 24,772	$ 409	$ 573	$ 20,948	$ 58	$ 1,706
Commercial construction	$ 11,652	$ 11,652	$	$ 13,091	$ 85	$ 353	$ 12,376	$ 69	$ 728
Consumer construction	$ 655	$ 655	$	$ 654	$ 22	$ 7	$ 874	$ 1	$ 24
Residential mortgage	$ 9,466	$ 9,466	$	$ 9,484	$ 191	$ 711	$ 10,402	$ 85	$ 1,506
Home equity & 2nd mortgage	$ 920	$ 920	$	$ 990	$ 20	$ 1,576	$ 915	$ 5	$ 2,021
Other consumer	$ 16	$ 16	$	$ 7	$	$	$ 168	$	$
With a related allowance:									
Commercial	7,134	7,283	149	1,901	103		39	2	
Commercial mortgage	2,432	2,456	24	4,137	35		3,876	74	128
Commercial construction							333		
Consumer construction							140	16	
Residential mortgage	8,072	8,274	202	8,363	322	168	12,139	388	703
Home equity & 2nd mortgage							18	3	
Other consumer									
Total:									
Commercial	$ 9,723	$ 9,872	$ 149	$ 5,796	$ 141	$ 187	$ 2,236	$ 9	$ 5,240
Commercial mortgage	$ 32,786	$ 32,810	$ 24	$ 28,909	$ 444	$ 573	$ 24,824	$ 132	$ 1,834
Commercial construction	$ 11,652	$ 11,652	$	$ 13,091	$ 85	$ 353	$ 12,709	$ 69	$ 728
Consumer construction	$ 655	$ 655	$	$ 654	$ 22	$ 7	$ 1,014	$ 17	$ 24
Residential mortgage	$ 17,538	$ 17,740	$ 202	$ 17,847	$ 513	$ 879	$ 22,541	$ 473	$ 2,209
Home equity & 2nd mortgage	$ 920	$ 920	$	$ 990	$ 20	$ 1,576	$ 933	$ 8	$ 2,021
Other consumer	$ 16	$ 16	$	$ 7	$	$	$ 168	$	$

	December 31, 2011		
	Recorded Investment	Unpaid Principal Balance	Related Allowance
	(dollars in thousands)		
With no related allowance:			
Commercial	$ 4,804	$ 4,804	$
	$ 21,039	$ 21,039	$

Commercial mortgage			
Commercial construction	$ 11,066	$ 11,066	$
Consumer construction	$ 718	$ 718	$
Residential mortgage	$ 8,723	$ 8,723	$
Home equity & 2nd mortgage	$ 905	$ 905	$
Other consumer	$	$	$
With a related allowance:			
Commercial	157	161	4
Commercial mortgage	5,249	5,306	57
Commercial construction			
Consumer construction			
Residential mortgage	9,075	9,297	222
Home equity & 2nd mortgage			
Other consumer			
Total:			
Commercial	$ 4,961	$ 4,965	$ 4
Commercial mortgage	$ 26,288	$ 26,345	$ 57
Commercial construction	$ 11,066	$ 11,066	$
Consumer construction	$ 718	$ 718	$
Residential mortgage	$ 17,798	$ 18,020	$ 222
Home equity & 2nd mortgage	$ 905	$ 905	$
Other consumer	$	$	$

The following table shows loans in nonaccrual status by class:

	September 30, 2012	December 31, 2011	September 30, 2011
	(dollars in thousands)		
Commercial	$ 2,156	$ 4,566	$ 4,238
Commercial mortgage	20,601	16,955	20,125
Commercial construction	4,580	5,949	6,549
Consumer construction	655	718	488
Residential mortgage	7,732	7,585	9,678
Home equity and 2nd mortgage	920	905	1,384
Other consumer	16		
	$ 36,660	$ 36,678	$ 42,462

The interest which would have been recorded on nonaccrual loans if those loans had been performing in accordance with their contractual terms for the nine months ended September 30, 2012 and 2011 was approximately $2.0 million and $1.4 million, respectively, and the actual interest income recorded on such loans for the nine months ended September 30, 2012 and 2011 was approximately $458,000 and $235,000, respectively.

The following table shows the breakdown of TDRs by portfolio segment:

	September 30, 2012	December 31, 2011	September 30, 2011
	(dollars in thousands)		
Commercial	$ 7,718	$ 422	$ 183
Commercial mortgage	17,839	10,296	5,205
Commercial construction	7,173	5,221	5,255
Consumer construction			406
Residential mortgage	11,717	11,908	13,211
Home equity and 2nd mortgage			413
Other consumer			
	$ 44,447	$ 27,847	$ 24,673
Nonaccrual TDRs (included in above totals)	$ 7,441	$ 2,506	$ 4,638

The following table shows the breakdown of loans we modified during the three and nine months ended September 30:

	Three Months Ended September 30,					
	2012			2011		
	Number of Modifications	Recorded Investment Prior to Modification	Recorded Investment After Modification	Number of Modifications	Recorded Investment Prior to Modification	Recorded Investment After Modification
	(dollars in thousands)					

Commercial	1	$ 7,125	$ 7,125	1	$ 297	$ 22
Commercial mortgage	2	18	18			
	3	$ 7,143	$ 7,143	1	$ 297	$ 22

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	Nine Months Ended September 30,					
	2012			2011		
	Number of Modifications	Recorded Investment Prior to Modification	Recorded Investment After Modification	Number of Modifications	Recorded Investment Prior to Modification	Recorded Investment After Modification
	(dollars in thousands)					
Commercial	3	$ 7,336	$ 7,336	2	$ 460	$ 185
Commercial mortgage	8	2,767	2,775	2	2,195	2,195
Commercial construction	2	7,093	7,093			
Residential mortgage	1	863	863	1	566	579
	14	$ 18,059	$ 18,067	5	$ 3,221	$ 2,959

The majority of our TDRs are the result of renewals where the only concession is that the interest rate is not considered to be a market rate. As such, the best illustration of the financial impact of the TDRs is the effect on the allowance for loan losses.

During the nine months ended September 30, 2012, the allowance for loan losses for TDRs was increased by $92,000 ($145,000 for commercial, offset by a reduction of $33,000 for commercial mortgage and $20,000 for residential mortgage). During the nine months ended September 30, 2012, we charged-off $245,000 for three TDR residential mortgage loans and one TDR commercial mortgage loan and transferred two TDR residential mortgage loans and one commercial mortgage loan for a total of $620,000 to real estate acquired through foreclosure.

The following table shows defaults during the stated period of modifications made during the previous year:

	Nine Months Ended September 30,			
	2012		2011	
	Number of Modifications	Recorded Investment	Number of Modifications	Recorded Investment
	(dollars in thousands)			
Commercial	1	$ 22	$	$

(5) Regulatory Matters, Capital Adequacy, and Liquidity

Regulatory matters and capital adequacy

Various regulatory capital requirements administered by the federal banking agencies apply to First Mariner and the Bank. Failure to meet minimum capital requirements can initiate certain mandatory, and possibly additional discretionary, actions by regulators that, if undertaken, could have a direct material effect on our financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The Bank s capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios of Total and Tier I capital to risk-weighted assets and of Tier I capital to average quarterly assets. As of September 30, 2012 and December 31, 2011, the Bank was undercapitalized under the regulatory framework for prompt corrective action.

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Our regulatory capital amounts and ratios as of September 30, 2012 and December 31, 2011 were as follows:

	Actual		Minimum Requirements for Capital Adequacy Purposes		To be Well Capitalized Under Prompt Corrective Action Provision	
	Amount	**Ratio**	**Amount**	**Ratio**	**Amount**	**Ratio**
			(dollars in thousands)			
September 30, 2012:						
Total capital (to risk-weighted assets):						
Consolidated	$ (7,090)	(0.8)%	$ 70,843	8.0%	$ 88,554	10.0%
Bank	62,457	7.1%	70,770	8.0%	88,463	10.0%
Tier I capital (to risk-weighted assets):						
Consolidated	(7,090)	(0.8)%	35,422	4.0%	53,132	6.0%
Bank	51,307	5.8%	35,385	4.0%	53,078	6.0%
Tier I capital (to average quarterly assets):						
Consolidated	(7,090)	(0.6)%	50,400	4.0%	63,000	5.0%
Bank	51,307	4.1%	50,363	4.0%	62,954	5.0%
December 31, 2011:						
Total capital (to risk-weighted assets):						
Consolidated	$ (22,393)	(2.6)%	$ 68,242	8.0%	$ 85,302	10.0%
Bank	46,659	5.5%	68,243	8.0%	85,304	10.0%
Tier I capital (to risk-weighted assets):						
Consolidated	(22,393)	(2.6)%	34,121	4.0%	51,181	6.0%
Bank	35,935	4.2%	34,122	4.0%	51,183	6.0%
Tier I capital (to average quarterly assets):						
Consolidated	(22,393)	(1.9)%	47,533	4.0%	59,416	5.0%
Bank	35,935	3.0%	47,468	4.0%	59,335	5.0%

The FDIC, through the Deposit Insurance Fund, insures deposits of accountholders up to $250,000, with the exception of noninterest-bearing transaction accounts, which are insured without limit through December 31, 2012. The Bank pays an annual premium to provide for this insurance.

The Bank is a member of the FHLB System and is required to maintain an investment in the stock of the FHLB based on specific percentages of outstanding mortgages, total assets, or FHLB advances. Purchases and sales of stock are made directly with the Bank at par value.

On September 18, 2009, the Bank entered into an Agreement with the FDIC and the Commissioner of Financial Regulation for the state of Maryland (the Commissioner), pursuant to which it consented to the entry of an Order to Cease and Desist (the September Order), which directs the Bank to (i) increase its capitalization, (ii) improve earnings, (iii) reduce nonperforming loans, (iv) strengthen management policies and practices, and (v) reduce reliance on noncore funding. The September Order required the Bank to adopt a plan to achieve and maintain a Tier I leverage capital ratio of at least 7.5% and a total risk-based capital ratio of at least 11% by June 30, 2010. As of September 30, 2012, we did not yet meet the requirements. The failure to achieve these capital requirements could result in further action by our regulators.

As part of the September Order, within 30 days after the end of each calendar year, the Bank must submit an annual budget and profit plan and a plan that takes into account the Bank s pricing structure, the Bank s cost of funds and how this can be reduced, and the level of provision expense for adversely classified loans. To address reliance on noncore funding, the Bank was required to submit a liquidity plan intended to reduce the Bank s reliance on noncore funding, wholesale funding sources, and high-cost rate-sensitive deposits. While the September Order is in effect, the Bank may not pay dividends or management fees without the FDIC s prior consent, may not accept, renew, or roll over any brokered deposits, and is restricted in the yields that it may pay on deposits.

First Mariner Bancorp is also a party to agreements with the Federal Reserve Bank (FRB) (the FRB Agreements), which, together, require it to: (i) develop and implement a strategic business plan that includes (a) actions that will be taken to improve our operating performance and reduce the level of parent company leverage, (b) a comprehensive budget and an expanded budget review process, (c) a description of the operating assumptions that form the basis for major projected income and expense components and provisions needed to maintain an adequate loan loss reserve, and (d) a capital plan incorporating all capital needs, risks, and regulatory guidelines; and (ii) submit plans to improve enterprise-wide risk management and effectiveness of internal audit programs. First Mariner Bancorp has also agreed to provide the FRB with advance notice of any significant capital transactions. The FRB Agreements also prohibit First Mariner and the Bank from taking any of the following actions without the FRB s prior written approval: (i) declaring or paying any dividends; (ii) taking dividends from the Bank; (iii) making any distributions of interest, principal, or other sums on First Mariner s subordinated debentures or trust preferred securities; (iv) incurring, increasing, or guaranteeing any debt; or (v) repurchasing or redeeming any shares of its stock. To satisfy the FRB s minimum capital requirements, First Mariner s consolidated Tier I capital to average quarterly assets, Tier I capital to risk-weighted assets, and total capital to risk-weighted assets ratios at each quarter end must be at least 4.0%, 4.0%, and 8.0%, respectively. At September 30, 2012, those capital ratios were (0.6)%, (0.8)%, and (0.8)%, respectively, which were not in compliance with the minimum requirements. The failure to achieve these capital requirements could result in further action by our regulators.

The foregoing will subject us to increased regulatory scrutiny and may have an adverse impact on our business operations. Failure to comply with the provisions of these regulatory requirements may result in more restrictive actions from our regulators, including more severe and restrictive enforcement actions.

Liquidity

The Bank s principal sources of liquidity are cash and cash equivalents (which are cash on hand and amounts due from financial institutions, federal funds sold, money market mutual funds, and interest bearing deposits), AFS securities, deposit accounts, and borrowings. The levels of such sources are dependent on the Bank s operating, financing, and investing activities at any given time. We attempt to primarily rely on core deposits from customers to provide stable and cost-effective sources of funding to support our loan growth. We also seek to augment such deposits with longer term and higher yielding certificates of deposit. Cash and cash equivalents, which totaled $111.2 million at September 30, 2012, have immediate availability to meet our short-term funding needs. Our entire securities portfolio is classified as AFS, is highly marketable (excluding our holdings of pooled trust preferred securities), and is available to meet our liquidity needs. Additional sources of liquidity include LHFS, which totaled $371.6 million at September 30, 2012, are committed to be sold into the secondary market, and generally are funded within 60 days and our residential real estate portfolio, which includes loans that are underwritten to secondary market criteria. Additionally, our residential construction loan portfolio provides a source of liquidity as construction periods generally range from 9-12 months, and these loans are subsequently refinanced with permanent first-lien mortgages and sold into the secondary market.

(6) Stock Options and Warrants

We have stock option plans, which provide for the granting of options to acquire First Mariner common stock to our directors and key employees. Option exercise prices are equal to or greater than the fair market value of the common stock on the date of the grant.

We account for stock options issued under our stockholder-approved Long-Term Incentive Plan (the Plan) in accordance with FASB guidance on share-based payments. The plan permits the granting of share options and shares to our directors and key employees. As of September 30, 2012, all options and warrants are fully vested and all compensation expense related to currently outstanding options and warrants has been recognized.

All options expire 10 years after the date of grant. The warrants expire five years after date of issuance.

Information with respect to stock options and warrants is as follows for the nine months ended September 30, 2012 and 2011:

	2012				2011			
	Number of Shares	**Weighted-Average Exercise Price**	**Weighted-Average Remaining Contractual Term** *(in years)*	**Aggregate Intrinsic Value** *(in thousands)*	**Number of Shares**	**Weighted-Average Exercise Price**	**Weighted-Average Remaining Contractual Term** *(in years)*	**Aggregate Intrinsic Value** *(in thousands)*
Outstanding at beginning of period	836,228	$ 7.98			930,228	$ 7.92		
Forfeited/cancelled	(245,400)	12.46			(89,650)	2.65		
Outstanding and exercisable at end of period	590,828	6.13	2.5	$	840,578	8.02	3.0	$

There were no options or warrants granted or exercised during 2012 or 2011.

Options and warrants outstanding are summarized as follows at September 30, 2012:

Exercise Price	Options and Warrants Outstanding and Exercisable *(shares)*	Weighted Average Remaining Contractual Life *(in years)*
$ 1.09	18,348	2.7
1.15	347,826	2.5
4.15	11,200	5.6
5.41	2,754	5.2
5.70	19,500	5.5
9.86	1,350	0.0
11.68	52,250	0.3
11.95	600	0.3
13.00	700	0.5
13.33	7,300	4.6
13.52	3,000	0.6
16.67	4,800	2.6
16.70	1,800	3.0
16.95	2,300	1.0
17.45	16,250	3.2
17.77	70,850	2.3
18.20	4,950	1.6
18.38	16,650	1.3
18.94	2,350	4.1
19.30	6,050	3.6
	590,828	

(7) Income (Loss) Per Share

Basic income (loss) per share is computed by dividing income (loss) available to common stockholders by the weighted-average number of common shares outstanding. Diluted income (loss) per share is computed after adjusting the denominator of the basic income (loss) per share computation for the effects of all dilutive potential common shares outstanding during the period. The dilutive effects of options, warrants, and their equivalents are computed using the treasury stock method. For the three and nine month periods ended September 30, 2012 and 2011, all options and warrants were antidilutive and excluded from the computations.

Information relating to the calculation of income (loss) per common share is summarized as follows for the three and nine months ended September 30:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Weighted-average share outstanding - basic and diluted	18,860,482	18,860,482	18,860,482	18,637,600
Net income (loss) *(dollars in thousands)*	$ 7,926	$ (7,960)	$ 15,418	$ (26,269)
Basic and diluted income (loss) per share	$ 0.42	$ (0.42)	$ 0.82	$ (1.41)

(8) Fair Value of Financial Instruments

We group financial assets and financial liabilities measured at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value. These levels are:

Level 1 Valuations for assets and liabilities traded in active exchange markets. Valuations are obtained from readily available pricing sources for market transactions involving identical assets or liabilities.

Level 2 Valuations for assets and liabilities traded in less active dealer or broker markets. Valuations are obtained from third party pricing services for identical or comparable assets or liabilities which use observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 3 Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

Financial Instruments Measured on a Recurring Basis

The following table presents fair value measurements for assets, liabilities, and off-balance sheet items that are measured at fair value on a recurring basis:

	September 30, 2012				
	Carrying Value	**Quoted Prices (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**	**Total Changes In Fair Values Included In Period Income**
	(dollars in thousands)				
Securities:					
Mortgage-backed securities	$ 5,556	$	$ 5,556	$	$
Trust preferred securities	9,081		8,224	857	(460)(1)
U.S. government agency notes	25,458		25,458		
U.S. Treasury securities	3,038		3,038		
Equity securities - banks	1,404		1,404		
Equity securities - mutual funds	797		797		
	$ 45,334	$	$ 44,477	$ 857	$ (460)
Warrants	$ 115	$	$	$ 115	$
LHFS	371,554		371,554		6,710
Interest rate lock commitments (IRLC or IRLCs) (notional amount of $174,119)	177,127		177,127		5,913
Forward contracts to sell mortgage-backed securities (notional amount of $187,519)	191,537		191,537		(14,509)

(1) Represents net OTTI charges taken on certain Level 3 securities

	December 31, 2011				
	Carrying Value	**Quoted Prices (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**	**Total Changes In Fair Values Included In Period Losses**
	(dollars in thousands)				
Securities:					
Mortgage-backed securities	$ 1,959	$	$ 1,959	$	$
Trust preferred securities	10,268		9,586	682	(838)(1)
U.S. government agency notes	8,518		8,518		
U.S. Treasury securities	1,004		1,004		
Equity securities - banks	151		151		
Equity securities - mutual funds	782		782		

	$ 22,682	$	$ 22,000	$ 682	$ (838)
Warrants	$ 18	$	$	$ 18	$
LHFS	182,992		182,992		4,164
IRLCs (notional amount of $138,075)	139,899		139,899		1,299
Forward contracts to sell mortgage-backed securities (notional amount of $102,250)	101,772		101,772		(7,527)

(1) Represents net OTTI charges taken on certain Level 3 securities

Level 3 Financial Instruments

Financial instruments are considered Level 3 when their values are determined using pricing models, discounted cash flow methodologies, or similar techniques and at least one significant model assumption or input is unobservable. Level 3 financial instruments also include those for which the determination of fair value requires significant management judgment or estimation.

AFS Securities

The fair value of AFS securities is based on bid quotations received from securities dealers, bid prices received from an external pricing service, or modeling utilizing estimated cash flows, depending on the circumstances of the individual security.

As of September 30, 2012, $857,000 ($10.9 million par value) of our AFS securities (four securities) were classified as Level 3, all of which were pooled trust preferred securities. The market environment has continued to be inactive for these security types and made fair value pricing more subjective.

The fair value of these four securities is primarily a function of the credit quality of the issuer, although there is some sensitivity to interest rate changes. A change in the rating of a security will affect its value.

The amount of Level 3 securities will likely continue to be a function of market conditions and additional security transfers from Level 2 to Level 3 could result if further market inactivity occurs.

The following table details the four Level 3 securities:

(dollars in thousands)	**Class**	**Remaining Par Value**	**Current Rating/Outlook (1) Moody s**	**Fitch**	**Maturity**	**(2) Auction Call Date**	**(3) Index**
ALESCO Preferred Funding VII	C-1	$ 1,000	Ca	C	7/23/2035	MAR 2015	3ML + 1.5%
ALESCO Preferred Funding XI	C-1	4,938	C	C	12/23/2036	JUNE 2016	3ML + 1.2%
MM Community Funding	B	2,500	Ca	C	8/1/2031	N/A	6ML + 3.1%
MM Community Funding IX	B-1	2,500	Ca	CC	5/1/2033	N/A	3ML + 1.8%

(1) Ratings as of September 30, 2012
(2) Under the terms of the offering, if the notes have not been redeemed in full prior to the indicated call date, then an auction of the collateral debt securities will be conducted and the collateral will be sold and the notes redeemed. If the auction is not successful, the collateral manager will conduct auctions on a quarterly basis until the rated notes are redeemed in full.
(3) 3/6ML - 3 or 6 Month LIBOR; LIBOR (London Interbank Offered Rate) - daily reference rate based on the interest rates at which banks offer to lend unsecured funds to other banks in the London wholesale money market or interbank market.

Classification of Level 3 indicates that significant valuation assumptions are not consistently observable in the market and, as such, fair values are derived using the best available data. We calculated fair value for these four securities by using a present value of future cash flows model, which incorporated assumptions as follows as of September 30, 2012:

	Cumulative Default (1)	**Deferrals Cured (2)**	**Credit MTM (3)(6)**	**Liquidity Premium (4)**	**Liquidity MTM Adj (5)(6)**
ALESCO Preferred Funding VII	50.00%	4.30%	$ 29.43	12.00%	$ 26.69
ALESCO Preferred Funding XI	36.00%	5.90%	49.41	12.00%	38.89
MM Community Funding	65.00%	1.90%	16.03	12.00%	10.29
MM Community Funding IX	55.00%	8.40%	50.35	12.00%	43.67

(1) The anticipated level of total defaults form the issuers within the pool of performing collateral as of September 30, 2012. There are no recoveries assumed on any default.
(2) Deferrals that are cured occur 60 months after the initial deferral starts.
(3) The credit mark to market represents the discounted value of future cash flows after the assumptions of current and future defaults discounted at the book rate of interest on the security.
(4) The risk of being unable to sell the instrument for cash at short notice without significant costs, usually indicative of the level of trading activity for a specific security or class of securities.
(5) The liquidity mark to market adjustment on the security represents the difference between the value of the discounted cash flows based on the book interest rate and the value discounted at the liquidity premium. The credit MTM less the liquidity MTM equals the estimated fair value price of the security.
(6) Price per $100.

Fair values were as follows:

	September 30, 2012	**December 31, 2011**

	Model Result (1)	Fair Value *(in thousands)*	Model Result (1)(2)	Fair Value *(in thousands)*
ALESCO Preferred Funding VII	$ 2.74	$ 27	$ 7.22	$ 72
ALESCO Preferred Funding XI	10.52	519	8.80	435
MM Community Funding	5.74	144	2.96	74
MM Community Funding IX	6.68	167	4.05	101
		$ 857		$ 682

(1) Price per $100
(2) Based on December 31, 2011 assumptions

During 2012 and 2011, we determined that OTTI had occurred in our pooled trust preferred security portfolio. The amount of OTTI that is recognized through earnings is determined by comparing the present value of the expected cash flows to the amortized cost of the security. The discount rate used to determine the credit loss is the expected book yield on the security. The credit loss estimated under the aforementioned method that was charged to operating earnings totaled $460,000 for the nine months ended September 30, 2012. No OTTI was recognized during the three months ended September 30, 2012. The credit loss that was charged to operating earnings totaled $681,000 and $818,000 for the three and nine months ended September 30, 2011, respectively.

Warrants

As of September 30, 2012, outstanding warrants were classified as Level 3. The fair value of the warrants is primarily a function of the Company s stock price. Changes in the price will create corresponding changes to the fair value of the warrants.

The table below presents a reconciliation of financial instruments measured at fair value on a recurring basis using significant unobservable inputs (Level 3) during the three months ended September 30, 2012 and 2011:

	2012		2011	
	Securities	Warrants	Securities	Warrants
	(dollars in thousands)			
Balance at beginning of period	$ 763	$ 118	$ 959	$ 162
Change in fair value included in additional paid-in capital		(3)		(114)
Total realized losses included in other comprehensive income (loss)			(681)	
Total unrealized gains included in accumulated other comprehensive loss	94		423	
Balance at end of period	$ 857	$ 115	$ 701	$ 48

The table below presents a reconciliation of financial instruments measured at fair value on a recurring basis using significant unobservable inputs (Level 3) during the nine months ended September 30, 2012 and 2011:

	2012		2011		
	Securities	Warrants	Securities	MSRs	Warrants
	(dollars in thousands)				
Balance at beginning of period	$ 682	$ 18	$ 987	$ 1,309	$ 137
MSR amortization				(135)	
Change in fair value included in additional paid-in capital		97			(89)
Reduction due to transfer of servicing rights				(1,174)	
Total realized losses included in other comprehensive income (loss)	(460)		(818)		
Total unrealized gains included in accumulated other comprehensive loss	635		532		
Balance at end of period	$ 857	$ 115	$ 701	$	$ 48

There were no transfers between any of Levels 1, 2, and 3 during either the three or nine months ended September 30, 2012 or September 30, 2011.

Other Financial Instruments Measured on a Recurring Basis

LHFS

LHFS are carried at fair value, which is determined based on outstanding investor commitments or, in the absence of such commitments, based on current investor yield requirements or third party pricing models.

IRLCs

We engage an experienced independent third party to estimate the fair market value of our IRLCs. IRLCs are valued based upon mandatory pricing quotes from correspondent lenders less estimated costs to process and settle the loan. Fair value is adjusted for the estimated probability of the loan closing with the borrower.

Forward Contracts to Sell Mortgage-Backed Securities

Fair value of these commitments is determined based upon the quoted market values of the securities.

Financial Instruments Measured on a Nonrecurring Basis

We may be required, from time to time, to measure certain other financial assets and liabilities at fair value on a nonrecurring basis. These adjustments to fair value usually result from application of lower-of-cost-or-market (LCM) accounting or write-downs of individual assets. For assets measured at fair value on a nonrecurring basis, the following tables provide the level of valuation assumptions used to determine each adjustment and the carrying value of the assets:

	September 30, 2012			
	Carrying Value	Quoted Prices (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
	(dollars in thousands)			
Impaired loans	$ 73,665	$	$	$ 73,665
Real estate acquired through foreclosure	19,978			19,978

	December 31, 2011			
	Carrying Value	Quoted Prices (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
	(dollars in thousands)			
Impaired loans	$ 62,019	$	$	$ 62,019
Real estate acquired through foreclosure	25,235			25,235

Impaired Loans

Allowable methods for estimating fair value for impaired loans include using the fair value of the collateral for collateral dependent loans or, where a loan is determined not to be collateral dependent, using the discounted cash flow method.

If the impaired loan is identified as collateral dependent, then the fair value method of measuring the amount of impairment is utilized. This method requires obtaining a current independent appraisal or utilizing some other method of valuation for the collateral and applying a discount factor to the value based on our loan review policy and procedures.

If the impaired loan is determined not to be collateral dependent, then the discounted cash flow method is used. This method requires the impaired loan to be recorded at the present value of expected future cash flows discounted at the loan s effective interest rate. The effective interest rate of a loan is the contractual interest rate adjusted for any net deferred loan fees or costs, premiums, or discounts existing at origination or acquisition of the loan.

For all loans other than TDRs, a partial charge-off is recorded to reduce the carrying amount of the loan to its fair value. For TDRs that have an estimated fair value that is below the carrying value, an allocation of the allowance for loan losses is established and remains part of the allowance until such time that it is determined the loan will proceed to foreclosure. Total impaired loans had a carrying value of $73.7 million and $62.0 million as of September 30, 2012 and December 31, 2011, respectively, with allocated reserves of $375,000 and $283,000 as of September 30, 2012 and December 31, 2011, respectively.

Real Estate Acquired Through Foreclosure

We record foreclosed real estate assets at the lower of cost or estimated fair value on their acquisition dates and at the lower of such initial amount or estimated fair value less estimated selling costs thereafter. Estimated fair value is generally based upon independent appraisal of the collateral or listing prices supported by broker recommendation. We consider these collateral values to be estimated using Level 3 inputs. We held real estate acquired through foreclosure of $20.0 million as of September 30, 2012 and $25.2 million as of December 31, 2011. During 2012, we added $6.3 million to real estate acquired through foreclosure and recorded write-downs and losses on sales, included in noninterest expense, of $1.8 million. We disposed of $9.7 million of foreclosed properties during 2012.

All Financial Instruments

The carrying value and estimated fair value of financial instruments are summarized in the following table. The descriptions of the fair value calculations for AFS securities and warrants are included in the discussions above.

	September 30, 2012				
		Fair Value			
	Carrying Value	Level 1	Level 2	Level 3	Total
Assets:			(dollars in thousands)		
Cash and cash equivalents	$ 111,207	$ 111,207	$	$	$ 111,207
AFS securities	45,334		44,477	857	45,334
LHFS	371,554		371,554		371,554
Loans receivable	643,468		566,971	73,665	640,636
Restricted stock investments	6,829	6,829			6,829
Liabilities:					
Deposits	1,108,151		1,118,296		1,118,296
Long- and short-term borrowings	120,828		123,565		123,565
Junior subordinated deferrable interest debentures	52,068		37,789		37,789
Warrants	115			115	115
Off Balance Sheet Items:					
IRLCs	177,127		177,127		177,127
Forward contracts to sell mortgage-backed securities	191,537		191,537		191,537

	December 31, 2011				
		Fair Value			
	Carrying Value	Level 1	Level 2	Level 3	Total
Assets:			(dollars in thousands)		
Cash and cash equivalents	$ 148,789	$ 148,789	$	$	$ 148,789
AFS securities	22,682		22,000	682	22,682
LHFS	182,992		182,992		182,992
Loans receivable	701,751		641,354	62,019	703,373
Restricted stock investments	7,085	7,085			7,085
Liabilities:					
Deposits	1,014,760		1,027,354		1,027,354
Long- and short-term borrowings	121,679		122,717		122,717
Junior subordinated deferrable interest debentures	52,068		36,902		36,902
Warrants	18			18	18
Off Balance Sheet Items:					
IRLCs	139,899		139,899		139,899
Forward contracts to sell mortgage-backed securities	101,772		101,772		101,772

Pricing or valuation models are applied using current market information to estimate fair value. In some cases considerable judgment is required to interpret market data to develop the estimates of fair value. Accordingly, the estimates presented herein are not necessarily indicative of the amounts the Company could realize in a current market exchange. The use of different market assumptions and/or estimation methods may have a material effect on the estimated fair value amounts.

Cash and Cash Equivalents

The carrying amount for cash and cash equivalents approximates fair value due to the short maturity of these instruments.

Loans Receivable

Loans were segmented into portfolios with similar financial characteristics. Loans were also segmented by loan class. Each loan class was further segmented by fixed and adjustable rate interest terms and performing and nonperforming categories. The fair value of each loan class was calculated by discounting anticipated cash flows based on weighted-average contractual maturity, weighted-average coupon, and discount rate.

The fair value for nonperforming loans was determined utilizing FASB guidance on loan impairment.

Restricted Stock Investments

The carrying value of restricted stock investments is a reasonable estimate of fair value as these investments do not have a readily available market.

Deposits

The fair value of deposits with no stated maturity, such as noninterest-bearing deposits, interest-bearing NOW accounts, money market, and savings accounts, is deemed to be equal to the carrying amounts. The fair value of certificates of deposit is based on the discounted value of contractual cash flows. The discount rate for certificates of deposit was estimated using the rate currently offered for deposits of similar remaining maturities.

Long- and Short-Term Borrowings and Junior Subordinated Deferrable Interest Debentures

Long- and short-term borrowings and junior subordinated notes were segmented into categories with similar financial characteristics. Carrying values were discounted using a cash flow approach based on market rates.

Other Off-Balance Sheet Financial Instruments

The disclosure of fair value amounts does not include the fair values of any intangibles, including core deposit intangibles. Core deposit intangibles represent the value attributable to total deposits based on an expected duration of customer relationships.

Limitations

Fair value estimates are made at a specific point in time, based on relevant market information and information about financial instruments. These estimates do not reflect any premium or discount that could result from a one-time sale of our total holdings of a particular financial instrument. Because no market exists for a significant portion of our financial instruments, fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments, and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect estimates.

(9) Segment Information

We are in the business of providing financial services, and we operate in two business segments commercial and consumer banking and mortgage-banking. Commercial and consumer banking is conducted through the Bank and involves delivering a broad range of financial services, including lending and deposit taking, to individuals and commercial enterprises. This segment also includes our treasury and administrative functions. Mortgage-banking is conducted through First Mariner Mortgage, a division of the Bank, and involves originating first- and second-lien residential mortgages for sale in the secondary market and to the Bank.

The following tables present certain information regarding our business segments:

Nine months ended September 30, 2012:

	Commercial and Consumer Banking	Mortgage-Banking	Total
	(dollars in thousands)		
Interest income	$ 28,269	$ 6,438	$ 34,707
Interest expense	9,456	2,280	11,736
Net interest income	18,813	4,158	22,971
Provision for loan losses	572		572
Net interest income after provision for loan losses	18,241	4,158	22,399
Noninterest income	4,044	35,450	39,494
Noninterest expense	37,611	9,069	46,680
Net intersegment income	1,112	(1,112)	
Net (loss) income before income taxes	$ (14,214)	$ 29,427	$ 15,213
Total assets	$ 922,480	$ 371,554	$ 1,294,034

Nine months ended September 30, 2011:

	Commercial and Consumer Banking	Mortgage-Banking	Total
	(dollars in thousands)		
Interest income	$ 33,309	$ 2,209	$ 35,518
Interest expense	14,042	883	14,925
Net interest income	19,267	1,326	20,593
Provision for loan losses	11,580		11,580
Net interest income after provision for loan losses	7,687	1,326	9,013
Noninterest income	7,585	7,942	15,527
Noninterest expense	44,321	6,488	50,809
Net intersegment income	1,674	(1,674)	
Net (loss) income before income taxes	$ (27,375)	$ 1,106	$ (26,269)
Total assets	$ 1,071,470	$ 126,191	$ 1,197,661

(10) Recent Accounting Pronouncements
Pronouncement Adopted

In September 2011, the FASB issued guidance on the reporting and presentation of comprehensive income. This guidance eliminates the option to present the components of other comprehensive income as part of the statement of changes in stockholders equity and requires an entity to present items of net income, other comprehensive income, and total comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The guidance also requires companies to display reclassification adjustments for each component of other comprehensive income in both net income and other comprehensive income. The Company adopted this pronouncement during the first quarter of 2012.

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

When used in this report, the terms the Company, we, us, and our refer to First Mariner Bancorp and, unless the context requires otherwise, its consolidated subsidiary. The following discussion should be read and reviewed in conjunction with Management s Discussion and Analysis of Financial Condition and Results of Operations set forth in First Mariner Bancorp s Annual Report on Form 10-K for the year ended December 31, 2011.

The Company

First Mariner Bancorp is a bank holding company incorporated under the laws of Maryland and registered under the federal Bank Holding Company Act of 1956, as amended. First Mariner Bancorp s business is conducted primarily through its wholly-owned subsidiary, First Mariner Bank (the Bank). The Company had over 570 employees (approximately 559 full-time equivalent employees) as of September 30, 2012.

The Bank, with assets of $1.3 billion as of September 30, 2012, is engaged in the general commercial banking business, with particular attention and emphasis on the needs of individuals and small to mid-sized businesses, and delivers a wide range of financial products and services that are offered by many larger competitors. The Bank s primary market area for its core banking operations, which consist of traditional commercial and consumer lending, as well as retail and commercial deposit operations, is central Maryland and portions of Maryland s eastern shore. Products and services of the Bank include traditional deposit products, a variety of consumer and commercial loans, residential and commercial mortgage and construction loans, wire transfer services, nondeposit investment products, and Internet banking and similar services. Most importantly, the Bank provides customers with access to local Bank officers who are empowered to act with flexibility to meet customers needs in an effort to foster and develop long-term loan and deposit relationships. The Bank is an independent community bank and its deposits are insured by the Federal Deposit Insurance Corporation (the FDIC).

First Mariner Mortgage, a division of the Bank, engages in mortgage-banking activities, providing mortgages and associated products to customers and selling most of those mortgages into the secondary market. First Mariner Mortgage had assets of $371.6 million and $183.0 million as of September 30, 2012 and December 31, 2011, respectively, and generated revenue of $41.9 million and $10.2 million, respectively, for the nine months ended September 30, 2012 and 2011. They recognized income before income taxes of $29.4 million and $1.1 million during the nine months ended September 30, 2012 and 2011, respectively. Origination volume during the nine months ended September 30, 2012 and 2011 was $1.8 billion and $691.8 million, respectively. During 2012, 50% of the originations were made in the state of Maryland, 15% in the immediately surrounding states and Washington, DC., and the remaining 35% in other states throughout the country. First Mariner Mortgage has offices in Maryland, Delaware, Virginia, and North Carolina. See Note 9 to the Consolidated Financial Statements for more detailed information on the results of our mortgage-banking operations.

Critical Accounting Policies

The Company s consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America (U.S.) (GAAP) and follow general practices within the industry in which it operates. Application of these principles requires management to make estimates, assumptions, and judgments that affect the amounts reported in the consolidated financial statements and accompanying notes. These estimates, assumptions, and judgments are based on information available as of the date of the consolidated financial statements; accordingly, as this information changes, the consolidated financial statements could reflect different estimates, assumptions, and judgments. Certain policies inherently have a greater reliance on the use of estimates, assumptions, and judgments and, as such, have a greater possibility of producing results that could be materially different than originally reported. Estimates, assumptions, and judgments are necessary when assets and liabilities are required to be recorded at fair value, when a decline in the value of an asset not carried on the consolidated financial statements at fair value warrants an impairment write-down or valuation reserve to be established, or when an asset or liability needs to be recorded contingent upon a future event. Carrying assets and liabilities at fair value inherently results in more financial statement volatility. When applying accounting policies in such areas that are subjective in nature, management must use its best judgment to arrive at the carrying value of certain assets and liabilities. Below is a discussion of our critical accounting policies.

Securities

We designate securities into one of three categories at the time of purchase. Debt securities that we have the intent and ability to hold to maturity are classified as held to maturity and recorded at amortized cost. Debt and equity securities are classified as trading if bought and held principally for the purpose of sale in the near term. Trading securities are reported at estimated fair value, with unrealized gains and losses included in earnings. Debt securities not classified as held to maturity and debt and equity securities not classified as trading securities are considered available for sale (AFS) and are reported at estimated fair value, with unrealized gains and losses reported as a separate component of stockholders deficit, net of tax effects, in accumulated other comprehensive loss.

Securities AFS are evaluated periodically to determine whether a decline in their value is other than temporary. The term other than temporary is not intended to indicate a permanent decline in value. Rather, it means that the prospects for near term recovery of value are not necessarily favorable, or that there is a lack of evidence to support fair values equal to, or greater than, the carrying value of the security.

The initial indications of other-than-temporary-impairment (OTTI) for both debt and equity securities are a decline in the market value below the amount recorded for a security and the severity and duration of the decline. In determining whether an impairment is other than temporary, we consider the length of time and the extent to which the market value has been below cost, recent events specific to the issuer, including investment downgrades by rating agencies and economic conditions of its industry, our intent to sell the security, and if it is more likely than not that we will be required to sell the security before recovery of its amortized cost basis. For marketable equity securities, we also consider the issuer s financial condition, capital strength, and near-term prospects. For debt securities and for perpetual preferred securities that are treated as debt securities for the purpose of OTTI analysis, we also consider the cause of the price decline (general level of interest rates and industry- and issuer-specific factors), the issuer s financial condition, near-term prospects and current ability to make future payments in a timely manner, the issuer s ability to service debt, and any change in agencies ratings at evaluation date from acquisition date and any likely imminent action. Once a decline in value is determined to be other than temporary, the security is segmented into credit- and noncredit-related components. Any impairment adjustment due to identified credit-related components is recorded as an adjustment to current period earnings, while noncredit-related fair value adjustments are recorded through accumulated other comprehensive loss. In situations where we intend to sell or it is more likely than not that we will be required to sell the security, the entire OTTI loss is recognized in earnings.

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Gains or losses on the sales of securities are calculated using a specific-identification basis and are determined on a trade-date basis. Premiums and discounts on securities are amortized (accreted) over the term of the security using methods that approximate the interest method. Gains and losses on trading securities are recognized regularly in income as the fair value of those securities changes.

Loans

Allowance for loan losses

Our allowance for loan losses represents an estimated amount that, in management s judgment, will be adequate to absorb probable incurred losses on existing loans. The allowance for loan losses consists of an allocated component and an unallocated component. Management uses a disciplined process and methodology to establish the allowance for losses each quarter. To determine the total allowance for loan losses, we estimate the reserves needed for each class of the portfolio, including loans analyzed individually and loans analyzed on a pooled basis. The allowance for loan losses consists of amounts applicable to: (1) the commercial loan portfolio; (2) the commercial mortgage loan portfolio; (3) the construction loan portfolios (both commercial and consumer); (4) the residential mortgage loan portfolio; (5) the home equity and second mortgage loan portfolio; and (6) the other consumer loan portfolio.

To determine the balance of the allowance account, loans are pooled by portfolio class and losses are modeled using historical experience, quantitative analysis, and other mathematical techniques over the loss emergence period. For each class of loan, significant judgment is exercised to determine the estimation method that fits the credit risk characteristics of that portfolio class. We use internally developed models in this process. Management must use judgment in establishing additional input metrics for the modeling processes. The models and assumptions used to determine the allowance are validated and reviewed to ensure that their theoretical foundation, assumptions, data integrity, computational processes, reporting practices, and end-user controls are appropriate and properly documented.

The establishment of the allowance for loan losses relies on a consistent process that requires multiple layers of management review and judgment and responds timely to changes in economic conditions and other influences. From time to time, events or economic factors may affect the loan portfolio, causing management to provide additional amounts to or release balances from the allowance for loan losses.

Management monitors differences between estimated and actual incurred loan losses utilizing charge-off history. Loans deemed uncollectible are charged against, while recoveries are credited to, the allowance. Management adjusts the level of the allowance through the provision for loan losses, which is recorded as a current period operating expense.

Commercial (including commercial mortgages) and construction loans (including both commercial and consumer) are generally evaluated for impairment when the loan becomes 90 days past due and/or is rated as substandard. The difference between the fair value of the collateral, less estimated selling costs and the carrying value of the loan is charged off at that time. Residential mortgage loans are generally charged down to their fair value when the loan becomes 120 days past due or is placed in nonaccrual status, whichever is earlier. Consumer loans are generally charged off when the loan becomes 120 days past due or when it is determined that the amounts due are uncollectible (whichever is earlier). The above charge-off guidelines may not apply if the loan is both well secured and in the process of collection. These charge-off policies have not changed in the last three years.

As an additional portion of the allowance for loan losses, we also estimate probable losses related to unfunded loan commitments. These commitments are subject to individual review and are analyzed for impairment the same as a correspondent loan would be.

Impairment

We determine a loan to be impaired when, based on current information and events, it is probable that we will be unable to collect all amounts due according to the contractual terms of the loan agreement. In general, impaired loans consist of nonaccrual loans and troubled debt restructures (TDR or TDRs). We do not consider a loan impaired during a period of delay in payment if we expect to collect all amounts due, including interest past due. Generally we consider a period of delay in payment to include delinquency up to 90 days, but may extend this period if the loan is collateralized by residential or commercial real estate with a low loan-to-value (LTV) ratio, and where collection and repayment efforts are progressing. We evaluate our commercial, commercial mortgage, commercial construction, and consumer construction classes of loans individually for impairment. We evaluate larger groups of smaller-balance homogeneous loans, which include our residential mortgage, home equity and second mortgage, and other consumer classes of loans, collectively for impairment.

We identify impaired loans and measure impairment (1) at the present value of expected cash flows discounted at the loan s effective interest rate, (2) at the observable market price, or (3) at the fair value of the collateral if the loan is collateral dependent. If our measure of the impaired loan is less than the recorded investment in the loan, we record a charge-off for the deficiency unless it s a TDR, for which we recognize an impairment loss through an allocated portion of the allowance for loan losses.

When the ultimate collectability of an impaired loan s principal is in doubt, wholly or partially, all cash receipts are applied to principal. Once the recorded principal balance has been reduced to zero, future cash receipts are applied to interest income, to the extent any interest has been foregone, and then they are recorded as recoveries of any amounts previously charged off. When this doubt no longer exists, cash receipts are applied under the contractual terms of the loan agreement.

Nonaccrual status

For smaller noncommercial loans, we place loans in nonaccrual status when they are contractually past due 90 days as to either principal or interest, unless the loan is well secured and in the process of collection, or earlier, when, in the opinion of management, the collection of principal and interest is in doubt. For all commercial loans, larger loans, and certain mortgage loans, management applies Financial Accounting Standards Board (FASB) guidance on impaired loan accounting to determine accrual status. Under that guidance, when it is probable that we will be unable to collect all payments due, including interest, we place the loan in nonaccrual status. A loan remains in nonaccrual status until the loan is current as to payment of both principal and interest and the borrower demonstrates the ability to pay and remain current. Specifically, in order for a nonaccrual loan to be returned to accrual status, a borrower must make six consecutive monthly payments and the borrower must demonstrate the ability to keep the loan current going forward. When a loan is partially charged off, the remaining balance remains in nonaccrual status.

As a result of our ongoing review of the loan portfolio, we may classify loans as nonaccrual even though the presence of collateral or the borrower s financial strength may be sufficient to provide for ultimate repayment. In general, loans are charged off when a loan or a portion thereof is considered uncollectible. We determine that the entire balance of a loan is contractually delinquent for all classes if the minimum payment is not received by the specified due date. Interest and fees continue to accrue on past due loans until the date the loan goes in nonaccrual status. We recognize interest on nonaccrual loans only when it is received.

Income recognition

Interest income on loans is accrued at the contractual rate based on the principal outstanding. Loan origination fees and certain direct loan origination costs are deferred and amortized as a yield adjustment over the contractual loan terms or until the date of sale or disposition. Accrual of interest is discontinued when its receipt is in doubt, which typically occurs when a loan becomes impaired. Any interest accrued to income in the year when interest accruals are discontinued is generally reversed. Management may elect to continue the accrual of interest when a loan is in the process of collection and the estimated fair value of the collateral is sufficient to satisfy the principal balance and accrued interest. Payments on nonaccrual loans are applied to principal. See additional information on loan impairment and nonaccrual status above.

Real estate acquired through foreclosure

We record real estate acquired through foreclosure at the lower of cost or market value (LCM) on the acquisition date and at the lower of such initial amount or estimated fair value less estimated selling costs thereafter. Estimated fair value is based upon many subjective factors, including location and condition of the property and current economic conditions, among other things. Because the calculation of fair value relies on estimates and judgments relating to inherently uncertain events, results may differ from our estimates.

Write-downs at the time of transfer are made through the allowance for loan losses. Write-downs subsequent to transfer are included in our noninterest expenses, along with operating income, net of related expenses of such properties and gains or losses realized upon disposition.

Income taxes

Deferred income taxes are recognized for the tax consequences of temporary differences between financial statement carrying amounts and the tax bases of assets and liabilities. Deferred income taxes are provided on income and expense items when they are reported for financial statement purposes in periods different from the periods in which these items are recognized in the income tax returns. Deferred tax assets are recognized only to the extent that it is more likely than not that such amounts will be realized based upon consideration of available evidence, including tax planning strategies and other factors.

The calculation of tax liabilities is complex and requires the use of estimates and judgment since it involves the application of complex tax laws that are subject to different interpretations by us and the various tax authorities. These interpretations are subject to challenge by the tax authorities upon audit or to reinterpretation based on management s ongoing assessment of facts and evolving case law.

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Periodically and in the ordinary course of business, we are involved in inquiries and reviews by tax authorities that normally require management to provide supplemental information to support certain tax positions we take in our tax returns. Uncertain tax positions are initially recognized in the financial statements when it is more likely than not the position will be sustained upon examination by the tax authorities. Such tax positions are initially and subsequently measured as the largest amount of tax benefit that is greater than 50% likely of being realized upon ultimate settlement with the tax authority assuming full knowledge of the position and all relevant facts. For tax positions not meeting the more likely than not test, no tax benefit is recorded. As of September 30, 2012 and December 31, 2011, we maintained a valuation allowance against the full amount of our deferred tax assets. Management believes it has taken appropriate positions on its tax returns, although the ultimate outcome of any tax review cannot be predicted with certainty. No assurance can be given that the final outcome of these matters will not be different than what is reflected in the current and historical financial statements.

We recognize interest and penalties related to income tax matters in income tax expense.

Financial Condition

Total assets increased to $1.3 billion at September 30, 2012 from $1.2 billion at December 31, 2011. Earning assets increased $140.4 million, or 14.6%, to $1.1 billion at September 30, 2012 from $959.1 million at December 31, 2011 primarily due mortgage-banking operations and the resultant $188.6 million increase in loans held for sale (LHFS). Deposits increased $93.4 million and our stockholders deficit decreased by $16.6 million.

Securities

We utilize the securities portfolio as part of our overall asset/liability management practices to enhance interest revenue while providing necessary liquidity for the funding of loan growth or deposit withdrawals. We continually monitor the credit risk associated with investments and diversify the risk in the securities portfolios. We held $45.3 million and $22.7 million, respectively, in securities classified as AFS as of September 30, 2012 and December 31, 2011.

Changes in current market conditions, such as interest rates and the economic uncertainties in the mortgage, housing, and banking industries have severely impacted the securities market. The secondary market for various types of securities has been limited and has negatively impacted security values. Quarterly, we review each security in our AFS portfolio to determine the nature of any decline in value and evaluate if any impairment should be classified as OTTI. For the nine months ended September 30, 2012, we determined that OTTI had occurred with respect to our pooled trust preferred securities portfolio in the amount of $460,000.

The trust preferred securities we hold in our securities portfolio were issued by other banks, bank holding companies, and insurance companies. As mentioned above, certain of these securities have experienced declines in credit ratings from credit rating firms, which have devalued these specific securities. While some of these issuers have reported weaker financial performance since acquisition of these securities, in management s opinion, they continue to possess acceptable credit risk. We monitor the actual default rates and interest deferrals for possible losses and contractual shortfalls of interest or principal, which could warrant further recognition of impairment.

All of the remaining securities that are impaired are so due to declines in fair values resulting from changes in interest rates or increased credit/liquidity spreads compared to the time they were purchased. We have the intent to hold these securities to maturity and it is more likely than not that we will not be required to sell the securities before recovery of value. As such, management considers the impairments to be temporary.

Our AFS securities portfolio composition is as follows:

	September 30, 2012	December 31, 2011
	(dollars in thousands)	
Mortgage-backed securities	$ 5,556	$ 1,959
Trust preferred securities	9,081	10,268
U.S. government agency notes	25,458	8,518
U.S. Treasury securities	3,038	1,004
	1,404	151

Equity securities - banks		
Equity securities - mutual funds	797	782
	$ 45,334	$ 22,682

LHFS

We originate residential mortgage loans for sale on the secondary market. At September 30, 2012 and December 31, 2011, such LHFS, which are carried at fair value, amounted to $371.6 million and $183.0 million, respectively.

When we sell mortgage loans we make certain representations to the purchaser related to loan ownership, loan compliance and legality, and accurate documentation, among other things. If a loan is found to be out of compliance with any of the representations subsequent to the date of purchase, we may be required to repurchase the loan or indemnify the purchaser for losses related to the loan, depending on the agreement with the purchaser. In addition other factors may cause us to be required to repurchase or make-whole a loan previously sold.

Prior to January 1, 2008, we used investor contracts that contained early payment default clauses that required us to repurchase and make-whole requests on loans sold prior to that date. We experienced losses on loans closed prior to 2008 due to borrower loan payment default. After January 1, 2008, we revised our contract and terms process to include the elimination of early payment default as a risk factor in the majority of our investor contracts and resulting loan sales. The most common reason for a loan repurchase for loans sold since January 1, 2008 is due to a documentation error or disagreement with an investor or on rare occasions for fraud. Repurchase requests are negotiated with each investor at the time we are notified of the demand and an appropriate reserve is taken at that time. Repurchase and or make-whole requests are initially negotiated by the secondary marketing department and monitored by the secondary marketing committee where most disagreements are resolved with no reserve requirement or loss to the Company. In the event there is an unresolved repurchase or make-whole request, the loan is managed by the secondary marketing committee and is elevated to be monitored by the mortgage overview committee to determine the final settlement terms with the investor. Repurchases amounted to $827,000 and $435,000 during the nine months ended September 30, 2012 and 2011, respectively. Our reserve for potential repurchases was $345,000 and $660,000 as of September 30, 2012 and December 31, 2011, respectively. These reserves were calculated based upon an analysis of the specific loans in question. We do not foresee increases in repurchases to be a growing trend nor do we see it having a significant impact on our financial results.

Loans

Our loan portfolio is expected to produce higher yields than investment securities and other interest-earning assets; the absolute volume and mix of loans and the volume and mix of loans as a percentage of total earning assets is an important determinant of our net interest margin.

The following table sets forth the composition of our loan portfolio:

	September 30, 2012	**Percent of Total**	**December 31, 2011**	**Percent of Total**
	(dollars in thousands)			
Commercial	$ 45,717	7.1%	$ 52,842	7.5%
Commercial mortgage	296,274	46.0%	326,530	46.5%
Commercial construction	48,319	7.5%	54,349	7.8%
Consumer construction	18,886	2.9%	16,280	2.3%
Residential mortgage	112,815	17.6%	121,119	17.3%
Consumer	121,457	18.9%	130,631	18.6%
Total loans	$ 643,468	100.0%	$ 701,751	100.0%

Total loans decreased $58.3 million during 2012. We experienced lower balances in all loan types, with the exception of consumer construction loans, which increased $2.6 million. We remained focused on improving asset quality to improve our capital ratios.

Commercial Construction Portfolio

Our commercial construction portfolio consists of construction and development loans for commercial purposes and includes loans made to builders and developers of residential real estate projects. Of the September 30, 2012 total included above, $21.4 million represents loans made to borrowers for the development of residential real estate. This segment of the portfolio has exhibited greater weakness (relative to our other loan segments) during 2011 and 2012 due to overall weakness in the residential housing sector.

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The breakdown of the portion of the commercial construction portfolio made to borrowers for residential real estate developments is as follows as of September 30, 2012 and December 31, 2011:

	September 30, 2012	December 31, 2011
	(dollars in thousands)	
Raw residential land	$ 5,227	$ 5,931
Residential subdivisions	4,213	4,171
Single residential lots	2,059	3,005
Single family construction	2,114	3,351
Townhome construction		209
Multi-family unit construction	7,776	5,561
	$ 21,389	$ 22,228

Transferred Loans

In accordance with FASB guidance on accounting for certain mortgage-banking activities, any loans which are originally originated for sale into the secondary market and which we subsequently transfer into the Company s loan portfolio are valued at fair value at the time of the transfer with any decline in value recorded as a charge to operating expense. We maintained $8.4 million in mortgage loans that were transferred from LHFS to our mortgage and consumer loan portfolios at September 30, 2012.

Credit Risk Management

Credit risk is the risk of loss arising from the inability of a borrower to meet its obligations and entails both general risks, which are inherent in the process of lending, and risks specific to individual borrowers. Our credit risk is mitigated through portfolio diversification, which limits exposure to any single customer, industry, or collateral type.

We manage credit risk by evaluating the risk profile of the borrower, repayment sources, the nature of the underlying collateral, and other support given current events, conditions, and expectations. We attempt to manage the risk characteristics of our loan portfolio through various control processes, such as credit evaluation of borrowers, establishment of lending limits, and application of lending procedures, including the holding of adequate collateral and the maintenance of compensating balances. However, we seek to rely primarily on the cash flow of our borrowers as the principal source of repayment. Although credit policies and evaluation processes are designed to minimize our risk, management recognizes that loan losses will occur and the amount of these losses will fluctuate depending on the risk characteristics of our loan portfolio, as well as general and regional economic conditions.

Management has an established methodology to determine the adequacy of the allowance for loan losses that assesses the risks and losses inherent in the loan portfolio. Our allowance methodology employs management s assessment as to the level of future losses on existing loans based on our internal review of the loan portfolio, including an analysis of the borrowers current financial position, and the consideration of current and anticipated economic conditions and their potential effects on specific borrowers and/or lines of business. In determining our ability to collect certain loans, we also consider the fair value of any underlying collateral. In addition, we evaluate credit risk concentrations, including trends in large dollar exposures to related borrowers, industry and geographic concentrations, and economic and environmental factors.

For purposes of determining the allowance for loan losses, we have segmented our loan portfolio by product type. Our loan segments are commercial, commercial mortgage, commercial construction, consumer construction, residential mortgage, and consumer. We have looked at all segments to determine if subcategorization into classes is warranted based upon our credit review methodology. As of September 30, 2012, we divided consumer loans into two classes, (1) home equity and second mortgage loans and (2) other consumer loans. For each class of loan, significant judgment is exercised to determine the estimation method that fits the credit risk characteristics of its portfolio segment. We use internally developed models in this process. Management must use judgment in establishing additional input metrics for the modeling processes. The models and assumptions used to determine the allowance are independently validated and reviewed to ensure that their theoretical foundation, assumptions, data integrity, computational processes, reporting practices, and end-user controls are appropriate and properly documented.

To establish the allowance for loan losses, which we do on a quarterly basis, loans are pooled by portfolio class and an historical loss percentage is applied to each class. The historical loss percentage is based upon a rolling 24 month history, which gives us the most current and relevant charge-off data. The result of that calculation for each loan class is then applied to the current loan portfolio balances to determine the required allowance for loan loss level per loan class. We then apply additional loss multipliers to the different classes of loans to reflect various environmental factors. This amount is considered our unallocated reserve. These factors capture any changes in economic trends, portfolio composition, real estate trends, as well as other factors and are meant to supplement the required reserves. For individually evaluated loans (impaired loans), we do additional analyses to determine the impairment amount (see below for more detail on these calculations). In general, this impairment amount is included as an allocated portion of the allowance for loan losses for TDRs and is charged off for all other impaired loans. These loss estimates are performed under multiple economic scenarios to establish a range of potential outcomes for each criterion. Management applies judgment to develop its own view of loss probability within that range, using external and internal parameters with the objective of establishing an allowance for loss inherent within these portfolios as of the reporting date.

See our charge-off policies under Critical Accounting Policies Loans Allowance for loan losses above.

See information on partial charge-offs later in this section.

Commercial

Credit risk in commercial lending, which includes commercial, commercial mortgage, commercial construction, and consumer construction loans, can vary significantly, as losses as a percentage of outstanding loans can shift widely during economic cycles and are particularly sensitive to changing economic conditions.

The risks associated with each portfolio class are as follows:

Commercial and Commercial Mortgage - The primary loan-specific risks in commercial and commercial mortgage loans are: deterioration of the business and/or collateral values, deterioration of the financial condition of the borrowers and/or guarantors, which creates a risk of default, and the risk that real estate collateral value determined through appraisals are not reflective of the true property values.

Portfolio risk includes condition of the economy, changing demand for these types of loans, large concentration of these types of loans, and geographic concentrations of these types of loans.

Commercial Construction loan-specific and portfolio risks related to commercial construction loans also carry the loan-specific and portfolio risks of commercial and commercial mortgage loans as described above. Additional loan-specific risks include project budget overruns and performance variables related to the contractor and subcontractors. An additional loan-specific risk for commercial construction of residential developments is the risk that the builder has a geographical concentration of developments.

Consumer Construction loan-specific and portfolio risks related to consumer construction loans to builders and ultimate homeowners carry the same loan-specific and portfolio risks as commercial construction loans as described above.

In general, improving economic conditions result in improved operating results on the part of commercial customers, enhancing their ability to meet debt service requirements. However, any improvements in operating cash flows can be offset by the impact of rising interest rates that could occur during improved economic times. Declining economic conditions have an adverse affect on the operating results of commercial customers, reducing their ability to meet debt service obligations.

Our commercial loans are generally reviewed individually, in accordance with FASB guidance on accounting for loan impairment, to determine impairment, accrual status, and the need for allocated reserves. We use creditworthiness categories to grade commercial loans. Our internal grading system is based on experiences with similarly graded loans and incorporates a variety of risk considerations, both qualitative and quantitative (see definitions of our various grades and the composition of our loan portfolio within those grades in Note 4 to the Consolidated Financial Statements). Quantitative factors include collateral values, financial condition of borrowers, and other factors. Qualitative factors include judgments concerning general economic conditions that may affect credit quality, credit concentrations, the pace of portfolio growth, and delinquency levels; these qualitative factors are evaluated in connection with the unallocated portion of our allowance for loan losses. We periodically engage outside firms and experts to independently assess our methodology and perform various loan review functions.

Consumer

Our consumer portfolio includes first- and second-lien mortgage loans and other loans to individuals. The risks associated with each portfolio class are as follows:

Residential Mortgage, Home Equity, and 2nd Mortgage The primary loan-specific risks related to residential mortgage, home equity, and 2nd mortgage lending include: unemployment, deterioration in real estate values, our ability to assess the creditworthiness of the customer, deterioration in the borrowers financial condition, whether the result of personal issues or a general economic downturn, and the risk that property values determined through appraisals are not reflective of the true property values. The portfolio risks for these types of loans are the same as for commercial and commercial mortgages as described above.

Other Consumer - The primary loan-specific risks of consumer loans are: unemployment, deterioration of the borrower s financial condition, whether the result of personal issues or a general economic downturn, and for certain consumer loans such as auto loans and boat loans, there is also a risk of deterioration in the value of the collateral. The portfolio risks for these types of loans are the same as for commercial and commercial mortgages as described above.

Generally, consumer loans are segregated into homogeneous pools with similar risk characteristics. We do not individually grade consumer loans. Such loans are classified as performing or nonperforming. Trends such as delinquency and loss and current economic conditions in consumer loan pools are analyzed and historical loss experience is adjusted accordingly. Quantitative and qualitative adjustment factors for the different consumer portfolios are consistent with those for the commercial portfolios.

Unallocated

The unallocated portion of the allowance is intended to provide for losses that are not identified when establishing the required portion of the allowance and is based upon management s evaluation of various conditions that are not directly measured in the determination of the formula and other allocated allowances. Such conditions include general economic and business conditions affecting key lending areas, credit quality trends (including trends in delinquencies and nonperforming loans expected to result from existing conditions), loan volumes, loan concentrations by class and geography and any changes in such concentrations, specific industry conditions within portfolio categories, duration of the current business cycle, bank regulatory examination results, and management s judgment with respect to various other conditions including changes in management, including credit, loan administration, and origination staff, changes in underwriting standards, lending policies, and procedures, the impact of any new or modified lines of business, level and trends in nonaccrual and delinquent loans and charge-offs, changes in underlying collateral for collateral dependent loans, and management and the quality of risk identification systems. Executive management reviews these conditions quarterly. Economic factors are an important consideration in determining the adequacy of the loan loss reserve. A strong regional and national economy will reduce the probability of losses. Weaker regional and national economies will usually result in higher unemployment, higher vacancies in commercial real estate, and declining values on both commercial and residential properties, which will gradually increase the probably of losses. Key measures of economic strength or weakness are unemployment levels, interest rates, and economic growth and confidence.

In calculating the range of unallocated reserves to be included in our allowance calculation, we apply a range of basis points to the respective portfolios for environmental factors. Each of these factors is evaluated quarterly. The bottom range would be zero. The top range consists of the basis points shown below for the respective portfolios as of September 30, 2012 and December 31, 2011. The actual unallocated portion of the allowance has been within this estimated range.

	September 30, 2012					
	Commercial	**Commercial Mortgage**	**Commercial Construction**	**Consumer Construction**	**Residential Mortgage**	**Consumer**
Concentration of credit and changes in level of concentration		5	5	8	10	
Nature and volume of portfolio		25	25	4	4	
Trends of past due and classified loans	15	17	17	8	8	
Economic factors	24	24	24	12	14	48
Value of underlying collateral for collateral dependent loans		25	25	23	23	5
	39	96	96	55	59	53

	December 31, 2011					
	Commercial	**Commercial Mortgage**	**Commercial Construction**	**Consumer Construction**	**Residential Mortgage**	**Consumer**
Concentration of credit and changes in level of concentration		5	5	8	10	
Nature and volume of portfolio		25	25	4	4	
Trends of past due and classified loans	1	9	9	8	8	
Economic factors	24	24	24	9	9	43
Value of underlying collateral for collateral dependent loans		21	21	21	21	5

25	84	84	50	52	48

We have risk management practices designed to ensure timely identification of changes in loan risk profiles; however, undetected losses may exist inherently within the loan portfolio. The assessments aspects involved in analyzing the quality of individual loans and assessing collateral values can also contribute to undetected, but probable, losses.

See additional detail on our allowance methodology and risk rating system in Note 4 to the Consolidated Financial Statements.

The following table summarizes the activity in our allowance for loan losses by portfolio segment for the three and nine months ended September 30:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	(dollars in thousands)			
Allowance for loan losses, beginning of period	$ 13,522	$ 14,115	$ 13,801	$ 14,115
Charge-offs:				
Commercial		(2,367)	(187)	(5,240)
Commercial mortgage	(253)	(1,325)	(573)	(1,834)
Commercial construction	(206)	(131)	(353)	(728)
Consumer construction			(7)	(24)
Residential mortgage	(365)	(670)	(879)	(2,209)
Consumer	(638)	(590)	(1,576)	(2,021)
Total charge-offs	(1,462)	(5,083)	(3,575)	(12,056)
Recoveries:				
Commercial				
Commercial mortgage			612	168
Commercial construction		24	52	24
Consumer construction				
Residential mortgage	5	23	425	37
Consumer	31	33	209	244
Total recoveries	36	80	1,298	473
Net charge-offs	(1,426)	(5,003)	(2,277)	(11,583)
Provision for loan losses		5,000	572	11,580
Allowance for loan losses, end of period	$ 12,096	$ 14,112	$ 12,096	$ 14,112
Loans (net of premiums and discounts):				
Period-end balance	$ 643,468	$ 736,672	$ 643,468	$ 736,672
Average balance during period	656,467	742,173	671,689	762,895
Allowance as a percentage of period-end loan balance	1.88%	1.92%	1.88%	1.92%
Percent of average loans:				
Provision for loan losses		2.67%	0.11%	2.03%
Net charge-offs	0.86%	2.67%	0.45%	2.03%

The following table summarizes our allocation of allowance by loan segment:

	September 30, 2012		December 31, 2011	
	Amount	Percent of Total	Amount	Percent of Total
	(dollars in thousands)			
Commercial	$ 1,996	16.5%	$ 2,768	20.1%
Commercial mortgage	1,608	13.3%	2,011	14.6%
Commercial construction	480	4.0%	1,809	13.1%
Consumer construction	221	1.8%	156	1.1%
Residential mortgage	1,578	13.0%	2,711	19.6%

Consumer	2,034	16.8%	2,632	19.1%
Unallocated	4,179	34.6%	1,714	12.4%
Total	$ 12,096	100.0%	$ 13,801	100.0%

Based upon management s evaluation, provisions are made to maintain the allowance as a best estimate of inherent losses within the portfolio. The allowance for loan losses totaled $12.1 million at September 30, 2012 and $13.8 million as of December 31, 2011. Any changes in the allowance from period to period reflect management s ongoing application of its methodologies to establish the allowance, which, in 2012, included decreases in the allowance for all loans segments, with the exception of consumer construction. Both the one increase and the remaining decreases are a reflection of the increase and decreases in the corresponding loan balances. We increased the unallocated portion of the allowance to reflect changes in relevant environmental factors (see detail above). We reduced the level of delinquencies and benefitted from a stabilizing economy and real estate market in 2012.

The provision for loan losses recognized to maintain the allowance was $0 and $572,000 for the three and nine months ended September 30, 2012 and 2011, respectively, and $5.0 million and $11.6 million for the three and nine months ended September 30, 2011, respectively. We recorded net charge-offs of $2.3 million during the first nine months of 2012 compared to net charge-offs of $11.6 million during the same period in 2011. During 2012, net charge-offs as compared to average loans outstanding decreased to 0.45%, compared to 2.0% during 2011. We generally record a significant amount of charge-offs as a result of our policy to charge off all fair value deficiencies instead of carrying an allocated portion of the allowance for loan losses (except with respect to nonaccrual TDRs). Partial charge-offs of nonaccrual loans decrease the amount of nonperforming and impaired loans, as well as any allocated allowance attributable to that loan. They decrease our allowance for loan losses, as well as our allowance for loan losses to nonperforming loans ratio and our allowance for loan losses to total loans ratio. Partial charge-offs increase our net charge-offs to average loans ratio. Total partial charge-offs of nonaccrual loans for the three and nine months ended September 30, 2012 amounted to $588,000 and $1.4 million, respectively. Total partial charge-offs of nonaccrual loans for the three and nine months ended September 30, 2011 amounted to $3.8 million and $5.2 million, respectively. The total amount of nonaccrual loans (prior to charge offs) for which we recorded partial charge-offs for the three and nine months ended September 30, 2012 was $7.2 million and $10.6 million, respectively, and the total amount of nonaccrual loans for which we recorded partial charge-offs for the three and nine months ended September 30, 2011 was $22.2 million and $37.4 million, respectively.

Our allowance as a percentage of outstanding loans has decreased from 1.97% as of December 31, 2011 to 1.88% as of September 30, 2012, reflecting the improvement in our asset quality.

Although management uses available information to establish the appropriate level of the allowance for loan losses, future additions or reductions to the allowance may be necessary based on estimates that are susceptible to change as a result of changes in economic conditions and other factors. As a result, our allowance for loan losses may not be sufficient to cover actual loan losses, and future provisions for loan losses could materially adversely affect our operating results. In addition, various regulatory agencies, as an integral part of their examination process, periodically review our allowance for loan losses and related methodology. Such agencies may require us to recognize adjustments to the allowance based on their judgments about information available to them at the time of their examination.

Management believes the allowance for loan losses is adequate as of September 30, 2012 and is sufficient to address the credit losses inherent in the current loan portfolio. We based this determination on several factors:

- We maintain appropriate oversight committees to track deteriorating credits thereby timely identifying potential problems and noting when current appraisals are due;
- We individually analyze all nonperforming assets (NPAs) and all credits risk rated 8 or above for impairment. We immediately charge off any deficiencies in collateral value that is identified in the impairment analysis (thus, placing all NPAs and risk-ratings (RR) of RR8 at fair value) (see additional detail related to risk ratings in Note 4 to the Consolidated Financial Statements);
- We calculate our required reserves based upon a rolling 24 month average of actual charge-offs, thereby utilizing current trend data of actual losses. These calculated loss percentages are then applied to our current loan balance by loan type to determine the required reserves;
- We apply environmental factors to calculate an unallocated reserve range. This unallocated reserve is meant to cover any negative economic and business trends that may develop; and
- The combination of the calculated required reserve plus the range of the unallocated reserve results in a total range to our allowance for loan losses. Our allowance for loan losses has been within the estimated ranges.

Our determination of the appropriate allowance level is based upon a number of assumptions we make about future events, which we believe are reasonable, but which may or may not prove valid. Thus, there can be no assurance that our charge-offs in future periods will not exceed our allowance for loan losses or that we will not need to make additional increases in our allowance for loan losses.

NPAs and Loans 90 Days Past Due and Still Accruing

Given the volatility of the real estate market, it is very important for us to have current appraisals on our NPAs. Generally, we annually obtain appraisals on NPAs. Previously, for residential and consumer nonperforming loans below $500,000, an alternative valuation method (AVM) may have been used in lieu of an appraisal. AVMs were obtained from an unrelated independent third party company. The third party valuation utilized a comparative sales based methodology analysis. It also had the ability to handle geographic anomalies, and advanced algorithms which, when coupled with access to multiple data sources, returned accurate and reliable valuation results. The turnaround time for these AVMs was generally within a few minutes of our request. As such, the use of AVMs in no way adversely impacted our overall valuation process, nor did it negatively affect the amount or timing of any provisions or charge-offs. In fact, the quick turnaround time of these AVMs helped identify potential losses immediately. There could be circumstances where we might utilize AVMs, along with additional corroborating procedures, again in the future.

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As part of our asset monitoring activities, we maintain a Workout Committee that meets three times per month. During these Workout Committee meetings, all NPAs and loan delinquencies are reviewed. We also produce an NPA report which is distributed weekly to senior management and is also discussed and reviewed at the Workout Committee meetings. This report contains all relevant data on the NPAs, including the latest appraised value and valuation date. Accordingly, these reports identify which assets will require an updated appraisal. As a result, we have not experienced any internal delays in identifying which loans/credits require appraisals. With respect to the ordering process of the appraisals, we have not experienced any delays in turnaround time nor has this been an issue over the past three years. Furthermore, we have not had any delays in turnaround time or variances thereof in our specific loan operating markets.

NPAs, expressed as a percentage of total assets, totaled 4.4% at September 30, 2012, 5.3% at December 31, 2011 and 5.6% at September 30, 2011. The ratio of allowance for loan losses to nonperforming loans was 33.0% at September 30, 2012, 37.6% at December 31, 2011, and 33.2% at September 30, 2011. The decrease in this ratio from December 31, 2011 to September 30, 2012 was primarily due to the decrease in the required allowance for loan losses.

The distribution of our NPAs and loans greater than 90 days past due and accruing is illustrated in the following table:

	September 30, 2012	December 31, 2011	September 30, 2011
		(dollars in thousands)	
Nonaccruing loans:			
Commercial	$ 2,156	$ 4,566	$ 4,238
Commercial mortgage	20,601	16,955	20,125
Commercial construction	4,580	5,949	6,549
Consumer construction	655	718	488
Residential mortgage	7,732	7,585	9,678
Consumer	936	905	1,384
	36,660	36,678	42,462
Real estate acquired through foreclosure:			
Commercial	1,516	83	1,463
Commercial mortgage	7,529	10,555	8,884
Commercial construction	5,466	6,174	6,255
Consumer construction	442	2,768	2,910
Residential mortgage	4,939	5,655	5,227
Consumer	86		
	19,978	25,235	24,739
Total NPAs	$ 56,638	$ 61,913	$ 67,201
Loans past-due 90 days or more and accruing:			
Commercial	$	$ 30	$ 118
Commercial mortgage		1,272	1,281
Commercial construction		2,032	
Consumer construction		238	
Residential mortgage		2,500	1,615
Consumer		244	309
	$	$ 6,316	$ 3,323

Nonaccrual loans amounted to $36.7 million at both September 30, 2012 and December 31, 2011. The commercial loan nonaccrual balance as of September 30, 2012 consisted of 11 loans, with the largest balance amounting to $828,000. Five loans in the amount of $457,000 were placed in nonaccrual status during 2012. All of the remaining nonaccrual commercial loans were in nonaccrual status as of December 31, 2011. Of the $4.6 million in nonaccrual commercial loans as of December 31, 2011, five loans for a total of $2.5 million were transferred to real estate acquired through foreclosure and three loans in the amount of $121,000 were paid off during the first nine months of 2012.

The commercial mortgage loan nonaccrual balance as of September 30, 2012 consisted of 38 loans, with the largest balance amounting to $5.1 million. We placed 16 commercial mortgage loans totaling $10.6 million in nonaccrual status in 2012. Of the balance at December 31, 2011, $2.2 million in commercial mortgage loans were transferred to real estate acquired through foreclosure during the first nine months of 2012, $3.9 million were paid off, and $415,000 were charged off.

The commercial construction nonaccrual balance as of September 30, 2012 consisted of seven loans, with the largest balance amounting to $3.1 million. All but $3,000 of the nonaccrual commercial construction loans as of September 30, 2012 were also in nonaccrual status as of December 31, 2011. Of the $5.9 million in commercial construction loans in nonaccrual status as of December 31, 2011, one loan in the amount of $119,000 was transferred to real estate acquired through foreclosure, $929,000 were charged off, and one loan in the amount of $317,000 was paid off during 2012.

The consumer construction nonaccrual balance as of September 30, 2012 consisted of four loans in the amount of $655,000, two of which ($410,000) were placed in nonaccrual status during 2012. Of the $718,000 in consumer construction loans in nonaccrual status at December 31, 2011, $332,000 were transferred to real estate acquired through foreclosure during 2012 and one loan in the amount of $128,000 was paid off during 2012.

The residential mortgage nonaccrual balance as of September 30, 2012 consisted of 32 loans, with the largest balance amounting to $828,000. We placed $2.7 million of these loans in nonaccrual status during the nine months ended September 30, 2012. Of the $7.6 million balance of nonaccrual residential mortgage loans at December 31, 2011, we transferred $1.9 million to real estate acquired through foreclosure, received pay-offs of $355,000, and charged off $206,000 during the first nine months of 2012.

The consumer loan nonaccrual balance as of September 30, 2012 consisted of 12 loans, 9 of which were placed in nonaccrual status during 2012. These loans are well secured and we have determined that they do not require charge-off as of September 30, 2012.

The interest which would have been recorded on nonaccrual loans if those loans had been performing in accordance with their contractual terms for the nine months ended September 30, 2012 and 2011 was approximately $2.0 million and $1.4 million, respectively, and the actual interest income recorded on such loans for the nine months ended September 30, 2012 and 2011 was approximately $458,000 and $235,000, respectively.

Real estate acquired through foreclosure decreased $5.3 million when compared to December 31, 2011, with increases in the commercial and consumer loan segments. We transferred $1.4 million in commercial loans to real estate acquired through foreclosure during the nine months ended September 30, 2012. The consumer loan balance represents one loan transferred to real estate acquired through foreclosure during 2012. The decreases in the remaining loan segments were due to resolution of the properties through foreclosure sales or buyouts.

The activity in our real estate acquired through foreclosure was as follows for the three and nine months ended September 30:

	Three Months Ended September 30,		**Nine Months Ended September 30,**	
	2012	**2011**	**2012**	**2011**
	(dollars in thousands)			
Balance at beginning of period	$ 22,433	$ 28,066	$ 25,235	$ 21,185
Real estate acquired in satisfaction of loans	1,633	1,868	6,283	16,073
Write-downs and losses on real estate acquired through foreclosure	(877)	(3,218)	(1,818)	(5,704)
Proceeds from sales of real estate acquired through foreclosure	(3,211)	(2,960)	(9,722)	(8,570)
Additional funds disbursed on real estate acquired through foreclosure		983		1,755
Balance at end of period	$ 19,978	$ 24,739	$ 19,978	$ 24,739

As of September 30, 2012, we did not have any Loans 90 days delinquent and accruing (loans that are well secured and in the process of collection). We held $6.3 million in such loans at December 31, 2011.

Not all of the loans newly classified as nonaccrual since December 31, 2011 required impairment reserves, as some of the loans   collateral had estimated fair values greater than the carrying amount of the loan or the loan has been written down to its estimated fair value. Additionally, in general, we charge off all impairment amounts immediately for all loans that are not TDRs.

TDRs

In situations where, for economic or legal reasons related to a borrower s financial difficulties, management may grant a concession for other than an insignificant period of time to the borrower that would not otherwise be considered, the related loan is classified as a TDR. Such concessions could include reductions in the interest rate, payment extensions, forgiveness of principal, forbearance, or other actions. These loans are excluded from pooled loss forecasts and a separate allocated portion of the allowance is provided under the accounting guidance for loan impairment. At the time that a loan is modified, management evaluates any possible impairment based on the present value of expected future cash flows, discounted at the contractual interest rate of the original loan agreement, except when the sole remaining source of repayment for the loan is the liquidation of the collateral. In these cases, we use the current fair value of the collateral, less selling costs, instead of discounted cash flows. Any impairment amount is then charged to the allowance.

The composition of our TDRs is illustrated in the following table at September 30, 2012 and December 31, 2011:

	September 30, 2012	December 31, 2011
	(dollars in thousands)	
Commercial:		
Nonaccrual	$ 3	$ 22
90 days or more and accruing	$	$
< 90 days past due/current	$ 7,715	$ 400
	7,718	422
Commercial mortgage:		
Nonaccrual	5,629	907
90 days or more and accruing		
< 90 days past due/current	12,210	9,389
	17,839	10,296
Commercial construction:		
Nonaccrual	101	103
90 days or more and accruing		
< 90 days past due/current	7,072	5,118
	7,173	5,221
Consumer construction:		
Nonaccrual		
90 days or more and accruing		
< 90 days past due/current		
Residential mortgage:		
Nonaccrual	1,708	1,474
90 days or more and accruing		2,164
< 90 days past due/current	10,009	8,270
	11,717	11,908
Consumer:		

Nonaccrual		
90 days or more and accruing		
< 90 days past due/current		
Totals:		
Nonaccrual	$ 7,441	$ 2,506
90 days or more and accruing	$	$ 2,164
< 90 days past due/current	$ 37,006	$ 23,177
	$ 44,447	$ 27,847

The interest income which would have been recorded on TDRs if those loans had performed in accordance with their contractual terms was approximately $1.6 million and $964,000 for the nine months ended September 30, 2012 and 2011, respectively. The actual interest income recorded on these loans for the nine months ended September 30, 2012 and 2011 was $890,000 and $562,000, respectively.

The following table shows the breakdown of loans modified during the three and nine months ended September 30:

	Three Months Ended September 30,					
	2012			2011		
	Number of Modifications	Recorded Investment Prior to Modification	Recorded Investment After Modification	Number of Modifications	Recorded Investment Prior to Modification	Recorded Investment After Modification
	(dollars in thousands)					
Commercial	1	$ 7,125	$ 7,125	1	$ 297	$ 22
Commercial mortgage	2	18	18			
	3	$ 7,143	$ 7,143	1	$ 297	$ 22

	Nine Months Ended September 30,					
	2012			2011		
	Number of Modifications	Recorded Investment Prior to Modification	Recorded Investment After Modification	Number of Modifications	Recorded Investment Prior to Modification	Recorded Investment After Modification
	(dollars in thousands)					
Commercial	3	$ 7,336	$ 7,336	2	$ 460	$ 185
Commercial mortgage	8	2,767	2,775	2	2,195	2,195
Commercial construction	2	7,093	7,093			
Residential mortgage	1	863	863	1	566	579
	14	$ 18,059	$ 18,067	5	$ 3,221	$ 2,959

Impaired Loans

The following tables show the breakout of impaired loans by class:

	September 30, 2012			Nine Months Ended September 30,					
				2012			2011		
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized	Charge-Offs	Average Recorded Investment	Interest Income Recognized	Charge-Offs
	(dollars in thousands)								
With no related allowance:									
Commercial	$ 2,589	$ 2,589	$	$ 3,895	$ 38	$ 187	$ 2,197	$ 7	$ 5,240
Commercial mortgage	$ 30,354	$ 30,354	$	$ 24,772	$ 409	$ 573	$ 20,948	$ 58	$ 1,706
Commercial construction	$ 11,652	$ 11,652	$	$ 13,091	$ 85	$ 353	$ 12,376	$ 69	$ 728
Consumer construction	$ 655	$ 655	$	$ 654	$ 22	$ 7	$ 874	$ 1	$ 24
Residential mortgage	$ 9,466	$ 9,466	$	$ 9,484	$ 191	$ 711	$ 10,402	$ 85	$ 1,506
	$ 920	$ 920	$	$ 990	$ 20	$ 1,576	$ 915	$ 5	$ 2,021

Home equity & 2nd mortgage									
Other consumer	$ 16	$ 16	$	$ 7	$	$	$ 168	$	$
With a related allowance:									
Commercial	7,134	7,283	149	1,901	103		39	2	
Commercial mortgage	2,432	2,456	24	4,137	35		3,876	74	128
Commercial construction							333		
Consumer construction							140	16	
Residential mortgage	8,072	8,274	202	8,363	322	168	12,139	388	703
Home equity & 2nd mortgage							18	3	
Other consumer									
Total:									
Commercial	$ 9,723	$ 9,872	$ 149	$ 5,796	$ 141	$ 187	$ 2,236	$ 9	$ 5,240
Commercial mortgage	$ 32,786	$ 32,810	$ 24	$ 28,909	$ 444	$485	$ 276		

Investment income from the Level 3 investments is reflected in other income (expense) in the accompanying condensed consolidated statements of income.

At September 30, 2016, there were no non-financial assets or liabilities required to be reported at fair value. We review our non-financial assets for impairment at least on an annual basis, as required.

Other Financial Assets and Liabilities

Financial assets with carrying values approximating fair value include cash and cash equivalents and accounts receivable. Financial liabilities with carrying values approximating fair value include accounts payable and other accrued liabilities and short-term debt. The fair value of cash and cash equivalents is measured using the comparable value in the active market and approximates its carrying value (Level 1 measurement). The fair value of short-term debt approximates the carrying value due to its short maturities and because interest rates approximate current market rates (Level 3 measurement).

At September 30, 2016, long-term debt, including current maturities but excluding a capital lease obligation, had a carrying value of approximately $151.8 million. This compares to a fair value of approximately $173.5 million, using a discounted cash flow methodology that incorporates a market interest rate based on published corporate borrowing rates for debt instruments with similar terms and average maturities, and with adjustments for duration, optionality, and risk profile. At December 31, 2015, long-term debt, including the current maturities but excluding a capital lease obligation, had a carrying value of approximately $153.7 million, compared to the estimated fair value of approximately $165.1 million. The valuation technique used to estimate the fair value of long-term debt would be considered a Level 3 measurement.

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14. Long-Term Debt

Our outstanding long-term debt is shown below:

(in thousands)	September 30, 2016	December 31, 2015
FPU secured first mortgage bonds [1] :		
9.08% bond, due June 1, 2022	$7,976	$ 7,973
Uncollateralized senior notes:		
6.64% note, due October 31, 2017	5,455	5,455
5.50% note, due October 12, 2020	10,000	10,000
5.93% note, due October 31, 2023	22,500	24,000
5.68% note, due June 30, 2026	29,000	29,000
6.43% note, due May 2, 2028	7,000	7,000
3.73% note, due December 16, 2028	20,000	20,000
3.88% note, due May 15, 2029	50,000	50,000
Promissory notes	168	238
Capital lease obligation	3,814	4,824
Total long-term debt	155,913	158,490
Less: current maturities	(12,087)	(9,151)
Less: debt issuance costs	(301)	(333)
Total long-term debt, net of current maturities	$143,525	$ 149,006

[1] FPU secured first mortgage bonds are guaranteed by Chesapeake Utilities.

Shelf Agreement

On October 8, 2015, we entered into a Shelf Agreement with Prudential. Under the terms of the Shelf Agreement, through October 8, 2018, we may request that Prudential purchase up to $150.0 million of our Shelf Notes at a fixed interest rate and with a maturity date not to exceed 20 years from the date of issuance. Prudential is under no obligation to purchase any of the Shelf Notes. The interest rate and terms of payment of any series of Shelf Notes will be determined at the time of purchase. We currently anticipate the proceeds from the sale of any series of Shelf Notes will be used for general corporate purposes, including refinancing of short-term borrowing and/or repayment of outstanding indebtedness and financing capital expenditures on future projects; however, actual use of such proceeds will be determined at the time of a purchase.

On May 13, 2016, we submitted a request that Prudential purchase $70.0 million of 3.25 percent Shelf Notes under the Shelf Agreement. On May 20, 2016, Prudential accepted and confirmed our request. The proceeds received from the issuances of the Shelf Notes will be used to reduce short-term borrowings under the Company's revolving credit facility, lines of credit and/or to fund capital expenditures. The closing of the sale and issuance of the Shelf Notes is expected to occur on or before April 28, 2017.

The Shelf Agreement sets forth certain business covenants to which we are subject when any Shelf Note is outstanding, including covenants that limit or restrict our ability, and the ability of our subsidiaries, to incur indebtedness, place or permit liens and encumbrances on any of our property or the property of our subsidiaries.

15. Short-Term Borrowing

On October 8, 2015, we entered into the Credit Agreement with the Lenders for a $150.0 million Revolver for a term of five years, subject to the terms and conditions of the Credit Agreement. Borrowings under the Revolver will be used for general corporate purposes, including repayments of short-term borrowings, working capital requirements and capital expenditures.

Borrowings under the Revolver will bear interest at: (i) the LIBOR Rate plus an applicable margin of 1.25 percent or less, with such margin based on total indebtedness as a percentage of total capitalization, both as defined by the Credit Agreement, or (ii) the base rate plus 0.25 percent or less. Interest will be payable quarterly, and the Revolver is subject to a commitment fee on the unused portion of the facility. We may extend the expiration date for up to two years on any anniversary date of the Revolver, with such extension subject to the Lenders' approval. We may also request the Lenders

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to increase the Revolver to $200.0 million, with any increase at the sole discretion of each Lender. At September 30, 2016 and December 31, 2015, we had outstanding borrowings of $50.0 million and $35.0 million, respectively, under the Revolver.

The net proceeds from the sale of our common stock on September 22, 2016, of approximately $57.3 million, after deducting underwriting commissions and expenses, were added to our general funds and used to repay a portion of our short-term debt under unsecured lines of credit.

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

Management's Discussion and Analysis of Financial Condition and Results of Operations is designed to provide a reader of the financial statements with a narrative report on our financial condition, results of operations and liquidity. This discussion and analysis should be read in conjunction with the attached unaudited condensed consolidated financial statements and notes thereto and our Annual Report on Form 10-K for the year ended December 31, 2015, including the audited consolidated financial statements and notes thereto.

Safe Harbor for Forward-Looking Statements

We make statements in this Quarterly Report on Form 10-Q that do not directly or exclusively relate to historical facts. Such statements are "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. One can typically identify forward-looking statements by the use of forward-looking words, such as "project," "believe," "expect," "anticipate," "intend," "plan," "estimate," "continue," "potential," "forecast" or other similar wo or conditional verbs such as "may," "will," "should," "would" or "could." These statements represent our intentions, plans, expectations, assumptions and beliefs about future financial performance, business strategy, projected plans and objectives of the Company. These statements are subject to many risks, uncertainties and other important factors that could cause actual results to differ materially from those expressed in the forward-looking statements. Such factors include, but are not limited to:

- state and federal legislative and regulatory initiatives (including deregulation) that affect cost and investment recovery, have an impact on rate structures and affect the speed at, and the degree to, which competition enters the electric and natural gas industries;
- the outcomes of regulatory, tax, environmental and legal matters, including whether pending matters are resolved within current estimates and whether the costs associated with such matters are adequately covered by insurance or recoverable in rates;
- the weather and other natural phenomena, including the economic, operational and other effects of hurricanes, ice storms and other damaging weather events;
- industrial, commercial and residential growth or contraction in our markets or service territories;
- the timing and extent of changes in commodity prices and interest rates;
- the capital-intensive nature of our regulated energy businesses;
- the extent of our success in connecting natural gas and electric supplies to transmission systems and in expanding natural gas and electric markets;
- the results of financing efforts, including our ability to obtain financing on favorable terms, which can be affected by various factors, including credit ratings and general economic conditions;
- the ability to establish and maintain new key supply sources;
- changes in environmental and other laws and regulations to which we are subject and environmental conditions of property that we now or may in the future own or operate;
- general economic conditions, including any potential effects arising from terrorist attacks and any hostilities or other external factors over which we have no control;
- conditions of the capital markets and equity markets during the periods covered by the forward-looking statements;
- the ability to continue to hire, train and retain appropriately qualified personnel;
- the creditworthiness of counterparties with which we are engaged in transactions;
- the effect of spot, forward and future market prices on our various energy businesses;

- the ability to construct facilities at or below estimated costs;
- possible increased federal, state and local regulation of the safety of our operations;
- the ability to successfully execute, manage and integrate merger, acquisition or divestiture plans, regulatory or other limitations imposed as a result of a merger, acquisition or divestiture, and the success of the business following a merger, acquisition or divestiture;
- the inherent hazards and risks involved in our energy businesses;
- risks related to cyber-attacks that could disrupt our business operations or result in failure of information technology systems.

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- the effect of competition on our businesses;
- the impact on our cost and funding obligations under our pension and other post-retirement benefit plans of potential downturns in the financial markets, lower discount rates, and costs associated with the Patient Protection and Affordable Care Act;
- the effect of accounting pronouncements issued periodically by accounting standard-setting bodies;
- the timing of regulatory and other governmental approvals, authorizations, and permits; and
- the loss of customers due to a government-mandated sale of our utility distribution facilities.

Introduction

We are a diversified energy company engaged, directly or through our operating divisions and subsidiaries, in various energy and other businesses.

Our strategy is focused on growing earnings from a stable utility foundation and investing in related businesses and services that provide opportunities for returns greater than traditional utility returns. The key elements of this strategy include:

- executing a capital investment program in pursuit of organic growth opportunities that generate returns equal to or greater than our cost of capital;
- expanding the regulated energy distribution and transmission businesses into new geographic areas and providing new services in our current service territories;
- expanding the propane distribution business in existing and new markets through leveraging our community gas system services, our vehicular fuel offerings and our bulk delivery capabilities;
- expanding both our regulated and unregulated energy businesses through strategic acquisitions;
- utilizing our expertise across our various businesses to improve overall performance;
- pursuing and entering new unregulated energy markets and business lines that will complement our existing strategy and operating units;
- enhancing marketing channels to attract new customers;
- providing reliable and responsive customer service to existing customers so they become our best promoters;
- engaging our customers through a distinctive service excellence initiative;
- developing and retaining a high-performing team that advances our goals;
- empowering and engaging our employees at all levels to live our brand and vision;
- demonstrating community leadership and engaging our local communities and governments in a cooperative and mutually beneficial way;
- maintaining a capital structure that enables us to access capital as needed;
- continuing to build a branded culture that drives a shared mission, vision, and values;
- maintaining a consistent and competitive dividend for stockholders; and
- creating and maintaining a diversified customer base, energy portfolio and utility foundation.

Due to the seasonality of our business, results for interim periods are not necessarily indicative of results for the entire fiscal year. Revenue and earnings are typically greater during the first and fourth quarters, when consumption of energy is normally highest due to colder temperatures.

The following discussions and those elsewhere in the document on operating income and segment results include the use of the term “gross margin.” “Gross margin” is determined by deducting the cost of sales from operating revenue. Cost of sales includes the purchased fuel cost for natural gas, electricity and propane and the cost of labor spent on direct revenue-producing activities. Gross margin should not be considered an alternative to operating income or net income, which are determined in accordance with GAAP. Chesapeake Utilities believes that gross margin, although a non-GAAP measure, is meaningful in our regulated operations because the cost of natural gas and electricity are passed through to customers and changes in commodity prices can cause revenue to go up and down in ways that are not indicative of volumes sold or tied to profitability. Gross margin provides investors with information that demonstrates the profitability achieved by Chesapeake Utilities under its allowed rates for regulated operations and under its competitive pricing structure for non-regulated segments. Chesapeake Utilities' management uses gross margin in measuring its business units’ performance and has historically analyzed and reported gross margin information publicly. Other companies may calculate gross margin in a different manner.

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Unless otherwise noted, earnings per share information is presented on a diluted basis.

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Results of Operations for the Three and Nine Months ended September 30, 2016

Overview and Highlights

Our net income for the quarter ended September 30, 2016 was $4.4 million, or $0.29 per share. This represents a decrease of $703,000, or $0.04 per share, compared to the net income of $5.1 million, or $0.33 per share, as reported for the same quarter in 2015. Operating income decreased $753,000 for the three months ended September 30, 2016. Gross margin increased by $4.7 million, although other operating expenses increased by $5.5 million. The increase in other operating expenses, in part, reflects the fact that the higher expenses to support growth of our businesses are largely recognized equally across the year, while the margin from this growth is more concentrated in the heating season during the fourth and first quarters.

	Three Months Ended September 30,		Increase
	2016	2015	(decrease)
(in thousands except per share)			
Business Segment:			
Regulated Energy segment	$13,115	$11,828	$ 1,287
Unregulated Energy segment	(3,080)	(1,022)	(2,058)
Other businesses and eliminations	121	103	18
Operating Income	$10,156	$10,909	$ (753)
Other (expense) income, net	(28)	36	(64)
Interest charges	2,722	2,492	230
Pre-tax Income	7,406	8,453	(1,047)
Income taxes	2,990	3,334	(344)
Net Income	$4,416	$5,119	$ (703)
Earnings Per Share of Common Stock			
Basic	$0.29	$0.34	$ (0.05)
Diluted	$0.29	$0.33	$ (0.04)

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Key variances, between the third quarter of 2015 and the third quarter of 2016, included:

(in thousands, except per share data)	Pre-tax Income	Net Income	Earnings Per Share
Third Quarter of 2015 Reported Results	$8,453	$5,119	$ 0.33
Increased (Decreased) Gross Margins:			
Eight Flags*	2,033	1,212	0.08
Service expansions*	1,577	940	0.06
Natural gas growth (excluding service expansions)	943	562	0.04
GRIP*	920	549	0.04
Implementation of Delaware Division interim rates*	469	280	0.02
Lower retail propane margins	(414)	(247)	(0.02)
Lower margins for Xeron	(413)	(246)	(0.02)
Aspire Energy*	(407)	(243)	(0.02)
	4,708	2,807	0.18
Decreased (Increased) Other Operating Expenses:			
Higher payroll and benefits costs	(1,830)	(1,091)	(0.07)
Eight Flags operating expenses	(1,065)	(635)	(0.04)
Higher outside services costs	(928)	(553)	(0.04)
Higher facility maintenance	(601)	(358)	(0.02)
Higher depreciation, asset removal and property tax costs	(466)	(278)	(0.02)
	(4,890)	(2,915)	(0.19)
Interest charges	(230)	(137)	(0.01)
Net Other Changes	(635)	(458)	(0.02)
Third Quarter of 2016 Reported Results	$7,406	$4,416	$ 0.29

*See the Major Projects and Initiatives table.

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Our net income for the nine months ended September 30, 2016 was $32.8 million, or $2.14 per share. This represents an increase of $291,000 or a decrease of $0.02 per share, compared to net income of $32.5 million, or $2.16 per share, as reported for the same period in 2015. Our growth projects and initiatives generated earnings that were offset by the effect of warmer weather, primarily in the normally colder first quarter, as well as the $1.4 million lower net settlement gain associated with the customer billing system. The warmer weather reduced year-to-date earnings per share by $0.31 compared to the same period last year.

	Nine Months Ended September 30,		Increase (decrease)
	2016	2015	
(in thousands except per share)			
Business Segment:			
Regulated Energy segment	$52,660	$47,616	$ 5,044
Unregulated Energy segment	9,267	13,666	(4,399)
Other businesses and eliminations	350	305	45
Operating Income	$62,277	$61,587	690
Other (expense) income, net	(68)	(3)	(65)
Interest charges	7,996	7,425	571
Pre-tax Income	54,213	54,159	54
Income taxes	21,401	21,638	(237)
Net Income	$32,812	$32,521	$ 291
Earnings Per Share of Common Stock			
Basic	$2.14	$2.16	$ (0.02)
Diluted	$2.14	$2.16	$ (0.02)

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Key variances, between the first nine months of 2015 and the first nine months of 2016, included:

(in thousands, except per share data)	Pre-tax Income	Net Income	Earnings Per Share
Nine months ended September 30, 2015 Reported Results	$54,159	$32,521	$ 2.16
Adjusting for Unusual Items:			
Weather impact, primarily in the first quarter	(7,548)	(4,533)	(0.31)
Net gain from settlement agreement associated with customer billing system	(1,367)	(821)	(0.06)
	(8,915)	(5,354)	(0.37)
Increased (Decreased) Gross Margins:			
Service expansions*	5,516	3,312	0.22
GRIP*	3,069	1,843	0.12
Natural gas growth (excluding service expansions)	2,630	1,579	0.11
Eight Flags*	2,581	1,550	0.10
Lower retail propane margins	(2,204)	(1,324)	(0.09)
Implementation of Delaware Division interim rates*	1,350	811	0.05
Natural gas marketing	1,062	638	0.04
Sandpiper SIR	618	371	0.03
	14,622	8,780	0.58
Decreased (Increased) Other Operating Expenses:			
Higher payroll and benefits costs	(2,144)	(1,287)	(0.09)
Higher depreciation, asset removal and property tax costs	(1,705)	(1,024)	(0.07)
Eight Flags operating expenses	(1,136)	(682)	(0.05)
Higher outside services costs	(1,100)	(661)	(0.04)
Higher facility maintenance	(787)	(473)	(0.03)
Lower bad debt, sales and advertising	427	256	0.02
	(6,445)	(3,871)	(0.26)
Net contribution from Aspire Energy, including impact of shares issued*	2,069	1,274	0.08
Interest Charges	(571)	(343)	(0.02)
Net Other Changes	(706)	(195)	(0.03)
Nine months ended September 30, 2016 Reported Results	$54,213	$32,812	$ 2.14

*See the Major Projects and Initiatives table.

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Summary of Key Factors
Major Projects and Initiatives

The following table summarizes gross margin for our major projects and initiatives completed since 2014 and our major projects and initiatives currently underway, but which will be completed in the future. Gross margin reflects operating revenue less cost of sales, excluding depreciation, amortization and accretion (dollars in thousands):

	Gross Margin for the Period							
	Three Months Ended		Nine Months Ended		Total			
	September 30,		September 30,		2015	Estimate for		
	2016	2015	2016	2015	Margin	2016	2017	2018
Major projects and initiatives completed since 2014	$12,083	$7,490	$34,086	$17,030	$25,270	$47,603	$54,258	$54,727
Major projects and initiatives underway [1]	—	—	—	—	—	—	5,255	20,238
	$12,083	$7,490	$34,086	$17,030	$25,270	$47,603	$59,513	$74,965

[1] This represents gross margin for the System Reliability and 2017 Expansion projects.

Major Projects and Initiatives Completed Since 2014
The following table summarizes gross margin generated by our major projects and initiatives completed since 2014 on an individual basis (dollars in thousands):

	Gross Margin for the Period									
	Three Months Ended			Nine Months Ended			Total			
	September 30,			September 30,			2015	Estimate for		
	2016	2015	Variance	2016	2015	Variance	Margin	2016	2017	2018
Acquisition:										
Aspire Energy	$1,630	$2,037	$(407)	$8,203	$3,661	$4,542	$6,324	$12,674	$13,376	$14,302
Natural Gas Transmission Expansions and Contracts:										
Short-term contracts										
New Castle County, Delaware	$664	$507	$157	$2,040	$1,998	$42	$2,682	$2,910	$2,275	$714
Kent County, Delaware	2,416	1,055	1,361	6,231	1,453	4,778	2,270	7,982	1,377	—
Total short-term contracts	$3,080	$1,562	$1,518	$8,271	$3,451	$4,820	$4,952	$10,892	$3,652	$714
Long-term contracts										
Kent County, Delaware	455	463	(8)	1,366	1,389	(23)	1,844	1,815	7,629	7,605
Polk County, Florida	407	340	67	1,221	501	720	908	1,627	1,627	1,627
Total long-term contracts	$862	$803	$59	$2,587	$1,890	$697	$2,752	$3,442	$9,256	$9,232
Total Expansions & Contracts	$3,942	$2,365	$1,577	$10,858	$5,341	$5,517	$7,704	$14,334	$12,908	$9,946
Florida GRIP	$2,987	$2,067	$920	$8,383	$5,314	$3,069	$7,508	$11,405	$13,756	$15,960
Florida Electric Rate Case	$1,021	$1,021	$—	$2,714	$2,714	$—	$3,734	$3,562	$3,562	$3,562
Delaware Division Rate Case	$469	$—	$469	$1,347	$—	$1,347	$—	$2,164	$2,500	$2,500
Eight Flags CHP Plant	$2,034	$—	$2,034	$2,581	$—	$2,581	$—	$3,464	$8,156	$8,457

Total Completed Major Projects and Initiatives	$12,083	$7,490	$4,593	$34,086	$17,030	$17,056	$25,270	$47,603	$54,258	$54,727

Aspire Energy
Aspire Energy's gross margin decreased by $407,000 for the three months ended September 30, 2016, partly due to increased deliveries and imbalance positions that favorably impacted Aspire Energy in the third quarter of 2015, which are non-recurring. Lower margin associated with system volumes and imbalance positions in third quarter of 2016 also contributed to the decrease.

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For the nine months ended September 30, 2016, Aspire Energy generated $4.5 million in additional gross margin compared to the same period in 2015. Aspire Energy's gross margin for the same period in 2015 was lower due in part to the fact that the period included only six months of results commencing on April 1, 2015. Aspire Energy also generated additional gross margin primarily as a result of pricing amendments to long-term gas sales agreements, additional management fees and the optimization of gathering system receipts and deliveries. As projected, this merger was accretive to earnings per share in the first full year of operations.

Service Expansions

On January 16, 2015, the Florida PSC approved a firm transportation agreement between Peninsula Pipeline and our Florida natural gas distribution division. Pursuant to this agreement, Peninsula Pipeline provides natural gas transmission service to support our expansion of natural gas distribution service in Polk County, Florida. Peninsula Pipeline began the initial phase of its service to Chesapeake Utilities' Florida natural gas distribution division in March 2015. This new service generated $67,000 and $720,000 of additional gross margin for the three and nine months ended September 30, 2016, respectively, compared to the same periods in 2015. When all phases of this service are complete, this expansion will generate an estimated annual gross margin of $1.6 million.

In April 2015, Eastern Shore commenced interruptible service to an electric power generator in Kent County, Delaware. The interruptible service concluded in December 2015 and was replaced by a short-term OPT ≤ 90 Service, which generated additional gross margin of $901,000 and $4.3 million during the three and nine months ended September 30, 2016, respectively, compared to the same periods in 2015. The short-term OPT ≤ 90 Service is expected to be replaced by a 20-year contract for OPT ≤ 90 Service in the first quarter of 2017.

On October 13, 2015, Eastern Shore submitted an application to the FERC to make certain measurement and related improvements at its TETLP interconnect facilities, which would enable Eastern Shore to increase natural gas receipts from TETLP by 53,000 Dts/d, for a total capacity of 160,000 Dts/d. In December 2015, the FERC authorized Eastern Shore to proceed with this project, which was completed and placed in service in March 2016. Approximately 85 percent of the increased capacity has been subscribed on a short-term firm service basis. This service generated an additional gross margin of $617,000 and $744,000 for the three and nine months ended September 30, 2016, respectively, compared to the same periods in 2015, and is expected to generate approximately $1.4 million in additional gross margin for the year. The remaining capacity is available for firm or interruptible service.

GRIP

GRIP is a natural gas pipe replacement program approved by the Florida PSC, designed to expedite the replacement of qualifying distribution mains and services (any material other than coated steel or plastic) to enhance reliability and integrity of the Florida natural gas distribution systems. This program allows recovery, through regulated rates, of capital and other program-related costs, inclusive of a return on investment, associated with the replacement of the mains and services. Since the inception of the program in August 2012, we have invested $97.3 million to replace 209 miles of qualifying distribution mains, including $20.4 million during the first nine months of 2016. We expect to invest an additional $650,000 in this program during the remainder of 2016. The increased investment in GRIP generated additional gross margin of $920,000 and $3.1 million for the three and nine months ended September 30, 2016, respectively, compared to the same periods in 2015.

Eight Flags

In June 2016, Eight Flags, completed construction of a CHP plant on Amelia Island, Florida. This CHP plant, which consists of a natural-gas-fired turbine and associated electric generator, produces approximately 20 megawatts of base load power and includes a heat recovery steam generator capable of providing approximately 75,000 pounds per hour of residual steam. On June 13, 2016, Eight Flags began selling power generated from the CHP plant to FPU, our wholly-owned subsidiary, pursuant to a 20-year power purchase agreement for distribution to its retail electric customers. On July 1, 2016, it also started selling steam to an industrial customer pursuant to a separate 20-year contract. The CHP plant is powered by natural gas transported by FPU through its distribution system. Eight Flags and other affiliates of Chesapeake Utilities generated $2.0 million and $2.6 million in additional gross margin as a result of these new services, for the three and nine months ended September 30, 2016 in which the CHP was operational. This amount includes gross margin of $464,000 and $892,000, for the three and nine months ended September 30, 2016, attributed to natural gas distribution and transportation services provided by our affiliates. On a consolidated basis, this project is expected to generate approximately $8.2 million in annual gross margin in 2017, which could fluctuate based upon various factors, including, but not limited to, the quantity of steam delivered and the CHP plant's hours of operations.

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Major Projects and Initiatives Underway

White Oak Mainline Expansion Project: In August 2014, Eastern Shore entered into a precedent agreement with an electric power generator in Kent County, Delaware, to provide a 20-year natural gas transmission service for 45,000 Dts/d for the customer's facility, upon the satisfaction of certain conditions. This new service will be provided as a long-term OPT ≤ 90 Service and is expected to generate at least $5.8 million in annual gross margin. In November 2014, Eastern Shore requested authorization by the FERC to construct 5.4 miles of 16-inch pipeline looping and 3,550 horsepower of new compression in Delaware to provide this service. As previously discussed, during the three and nine months ended September 30, 2016, compared to the same periods in 2015, we generated $901,000 and $4.3 million, respectively, in additional gross margin by providing interruptible service and short-term OPT ≤ 90 Service to this customer. On July 21, 2016, the FERC issued a certificate of public convenience and necessity authorizing Eastern Shore to construct and operate the proposed White Oak Mainline Project. Construction of the project is underway.

System Reliability Project: On May 22, 2015, Eastern Shore submitted an application to the FERC, seeking authorization to construct, own and operate approximately 10.1 miles of 16-inch pipeline looping and auxiliary facilities in New Castle and Kent Counties, Delaware and a new compressor at its existing Bridgeville compressor station in Sussex County, Delaware. Eastern Shore further proposes to reinforce critical points on its pipeline system. The total project will benefit all of Eastern Shore’s customers by modifying the pipeline system to respond to severe operational conditions experienced during actual winter peak days. Since the project is intended to improve system reliability, Eastern Shore requested a predetermination of rolled-in rate treatment for the costs of the project and an order granting the requested authorization. This project will be included in Eastern Shore's upcoming 2017 rate case filing. The estimated annual gross margin associated with this project, assuming recovery in the 2017 rate case, is approximately $4.5 million. On July 21, 2016, the FERC issued a certificate of public convenience and necessity authorizing Eastern Shore to construct and operate the proposed System Reliability Project. Construction of the project is underway.

2017 Expansion Project: On May 12, 2016, Eastern Shore submitted a request to the FERC to initiate the FERC's pre-filing procedures for its proposed 2017 Expansion Project. Since the time the pre-filing was initiated, Eastern Shore has finalized market participation for the project. Seven of Eastern Shore’s existing customers have signed Precedent Agreements. As a result, the project will provide 61,162 Dts/d of additional firm natural gas transportation deliverability on Eastern Shore’s pipeline system. To provide this additional capacity, the project’s final facilities will consist of approximately 23 miles of pipeline looping in Pennsylvania, Maryland and Delaware; upgrades to existing metering facilities in Lancaster County, Pennsylvania; installation of an additional 3,550 horsepower compressor unit at Eastern Shore’s existing Daleville compressor station in Chester County, Pennsylvania; and approximately 17 miles of new mainline extension and two pressure control stations in Sussex County, Delaware. The project will generate approximately $15.7 million in the first full year after the new transportation services go into effect.

Other factors influencing gross margin

Weather and Consumption

Although weather was not a significant factor in the second and third quarters, warmer temperatures during the first three months of the year, compared to temperatures in 2015, had a significant impact on the our earnings. Lower customer consumption, directly attributable to warmer temperatures during the nine months ended September 30, 2016, reduced gross margin by $7.5 million compared to the same period in 2015. The following tables summarize the HDD and CDD information for the three and nine months ended September 30, 2016 and 2015 resulting from weather fluctuations in those periods.

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HDD and CDD Information

	Three Months Ended September 30,			Nine Months Ended September 30,		
	2016	2015	Variance	2016	2015	Variance
Delmarva						
Actual HDD	11	41	(30)	2,590	3,249	(659)
10-Year Average HDD ("Delmarva Normal")	65	65	—	2,919	2,908	11
Variance from Delmarva Normal	(54)	(24)		(329)	341	
Florida						
Actual HDD	—	—	—	646	501	145
10-Year Average HDD ("Florida Normal")	—	—	—	553	557	(4)
Variance from Florida Normal	—	—		93	(56)	
Ohio [1]						
Actual HDD	65	78	(13)	3,747	710	3,037
10-Year Average HDD ("Ohio Normal")	137	143	(6)	3,979	811	3,168
Variance from Ohio Normal	(72)	(65)		(232)	(101)	
Florida						
Actual CDD	1,523	1,591	(68)	2,737	2,827	(90)
10-Year Average CDD ("Florida CDD Normal")	1,523	1,524	(1)	2,548	2,506	42
Variance from Florida CDD Normal	—	67		189	321	

(1) HDD for Ohio is presented from April 1, 2015 through September 30, 2015.

Propane prices

Lower retail propane margins per gallon on the Delmarva Peninsula decreased gross margin by $344,000 and $2.2 million, for the three and nine months ended September 30, 2016, respectively, compared to the same periods in 2015. Margins per retail gallon returned to more normal levels, driven principally by lower propane prices and local market conditions. The level of retail margins per gallon generated during 2015 were not expected to be sustained over the long term; accordingly, we have continued to assume more normal levels of margins in our long-term financial plans and forecasts.

In Florida, retail propane margins per gallon, generated $70,000 of lower margin and $61,000 of additional gross margin for the three and nine months ended September 30, 2016, respectively, compared to the same periods in 2015.

These market conditions, which are influenced by competition with other propane suppliers as well as the availability and price of alternative energy sources, may fluctuate based on changes in demand, supply and other energy commodity prices.

Other Natural Gas Growth - Distribution Operations

In addition to service expansions, the natural gas distribution operations on the Delmarva Peninsula generated $253,000 and $1.1 million in additional gross margin for the three and nine months ended September 30, 2016, respectively, compared to the same periods in 2015, due to an increase in residential, commercial and industrial customers served. The average number of residential customers on the Delmarva Peninsula during the three and nine months ended September 30, 2016, increased by 4.2 percent and 3.5 percent, respectively, compared to the same periods in 2015. The natural gas distribution operations in Florida generated $350,000 and $1.1 million in additional gross margin for the three and nine months ended September 30, 2016, respectively, compared to the same periods in 2015, due primarily to an increase in commercial and industrial customers in Florida.

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Delaware Division rate case

On December 21, 2015, our Delaware Division filed an application with the Delaware PSC for a base rate increase and certain other changes to its tariff. We proposed an increase of approximately $4.7 million, or nearly ten percent, in our revenue requirement based on the test period ending March 31, 2016. We also proposed new service offerings to promote growth and a revenue normalization mechanism for residential and small commercial customers. We expect a decision on the application during the first quarter of 2017. Pending the decision, our Delaware Division increased rates on an interim basis based on the $2.5 million annualized interim rates approved by the Delaware PSC, effective February 19, 2016 ("Phase I"). We recognized incremental revenue of approximately $469,000 ($280,000 net of tax) and $1.4 million ($817,000 net of tax) for the three and nine months ended September 30, 2016, respectively.

In addition, our Delaware Division requested and received approval on July 26, 2016 from the Delaware PSC to implement revised interim rates totaling $4.7 million (equal to the initial rate increase in our application) annualized for usage on and after August 1, 2016 ("Phase II"). These revised interim rates represent a five percent increase over Phase I rates. Revenue associated with these rates collected prior to a final Delaware PSC decision is subject to refund and, although the final decision is expected during the first quarter of 2017, we cannot predict the revenue requirement the Delaware PSC will ultimately authorize or forecast the timing of a final decision. Consequently, we will not recognize the impact of the potential additional revenue related to the Phase II rate increase until the Delaware PSC issues its approval in a final ruling.

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Regulated Energy Segment

For the quarter ended September 30, 2016 compared to the quarter ended September 30, 2015

	Three Months Ended September 30,		Increase
	2016	2015	(decrease)
(in thousands)			
Revenue	$70,019	$63,796	$ 6,223
Cost of sales	24,644	23,161	1,483
Gross margin	45,375	40,635	4,740
Operations & maintenance	22,912	19,882	3,030
Depreciation & amortization	6,346	6,129	217
Other taxes	3,002	2,796	206
Other operating expenses	32,260	28,807	3,453
Operating income	$13,115	$11,828	$ 1,287

Operating income for the Regulated Energy segment for the quarter ended September 30, 2016 was $13.1 million, an increase of $1.3 million, or 10.9 percent, compared to the same quarter in 2015. The increased operating income was due primarily to an increase in gross margin of $4.7 million, partially offset by an increase in operating expenses of $3.4 million.

Gross Margin

Items contributing to the quarter-over-quarter increase of $4.7 million, or 11.7 percent, in gross margin are listed in the following table:

(in thousands)	
Gross margin for the three months ended September 30, 2015	$40,635
Factors contributing to the gross margin increase for the three months ended September 30, 2016:	
Service expansions	1,577
Natural gas growth (excluding service expansions)	943
Additional revenue from GRIP in Florida	920
Implementation of Delaware Division interim rates	469
Margin from service to Eight Flags	464
Sandpiper SIR	226
Other	141
Gross margin for the three months ended September 30, 2016	$45,375

The following is a narrative discussion of the significant items, which we believe is necessary to understand the information disclosed in the foregoing table.

Service Expansions

Increased gross margin from natural gas service expansions was generated primarily from the following:

- $901,000 attributable to $1.9 million from the short-term OPT ≤ 90 Service that commenced in December 2015 to an electric power generator in Kent County, Delaware and offset by a $1.0 million decrease in gross margin from the conclusion of the interruptible service Eastern Shore provided this customer in 2015. The short-term OPT ≤ 90 Service is expected to be replaced by a 20-year OPT ≤ 90 Service in the first quarter of 2017.
- $617,000 from short-term firm service that commenced in March 2016, following certain measurement and related improvements to Eastern Shore's interconnect with TETLP that increased its natural gas receipt capacity from TETLP by 53,000 Dts/d, for a total capacity of 160,000 Dts/d. This service will generate approximately $1.4 million in additional gross margin in 2016. The remaining capacity is available for firm or interruptible service.

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Natural Gas Growth (excluding service expansions)

Increased gross margin of $943,000 from other growth in natural gas (excluding service expansions) was generated primarily from the following:

- $368,000 from Eastern Shore interruptible service provided to customers;
- $350,000 from Florida natural gas customer growth due primarily to new services to commercial and industrial customers; and
- $253,000 from a 4.2 percent increase in the average number of residential customers in the Delmarva natural gas distribution operations, as well as growth in the number of commercial and industrial customers.

Additional Revenue from GRIP in Florida

Additional GRIP investments during 2015 and 2016 by our Florida natural gas distribution operations generated $920,000 in additional gross margin in the third quarter of 2016, compared to the same period in 2015.

Implementation of Delaware Division Interim Rates

Delaware Division generated additional gross margin of $469,000 from the implementation of interim rates as a result of its rate case filing. See Note 4, Rates and Other Regulatory Activities, to the condensed consolidated financial statements for additional details.

Margin from service to Eight Flags

We generated additional gross margin of $464,000 in the third quarter of 2016, compared to the same period in 2015, from new natural gas transmission and distribution services provided to our Eight Flags' CHP plant.

Sandpiper SIR

Sandpiper generated additional gross margin of $226,000, in the third quarter of 2016, compared to the same period in 2015, from a higher system improvement rate resulting from the continuing conversion of the Sandpiper system from propane service to natural gas service.

Other Operating Expenses

Other operating expenses increased by $3.4 million. The significant components of the increase in other operating expenses included:

- $1.3 million in higher payroll and benefits costs for additional personnel to support growth;
- $702,000 in higher outside services costs primarily associated with growth and ongoing compliance activities;
- $517,000 in higher facilities costs to support growth; and
- $401,000 in higher depreciation, asset removal and property tax costs associated with recent capital investments to support growth and system integrity.

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For the nine months ended September 30, 2016 compared to the nine months ended September 30, 2015

	Nine Months Ended September 30, 2016	2015	Increase (decrease)
(in thousands)			
Revenue	$226,630	$235,438	$(8,808)
Cost of sales	81,184	101,414	(20,230)
Gross margin	145,446	134,024	11,422
Operations & maintenance	64,673	59,648	5,025
Depreciation & amortization	18,909	18,109	800
Other taxes	9,204	8,650	554
Other operating expenses	92,786	86,407	6,379
Operating income	$52,660	$47,617	$5,043

Operating income for the Regulated Energy segment for the nine months ended September 30, 2016 was $52.7 million, an increase of $5.0 million, or, 10.6 percent, compared to the same period in 2015. The increased operating income was primarily due to an increase in gross margin of $11.4 million partially offset by a $6.4 million increase in operating expenses to support growth.

Gross Margin

Items contributing to the period-over-period increase of $11.4 million, or 8.5 percent, in gross margin are listed in the following table:

(in thousands)	
Gross margin for the nine months ended September 30, 2015	$134,024
Factors contributing to the gross margin increase for the nine months ended September 30, 2016:	
Service expansions	5,516
Additional revenue from GRIP in Florida	3,069
Natural gas growth (excluding service expansions)	2,630
Implementation of Delaware Division interim rates	1,350
Margin from service to Eight Flags	892
Sandpiper SIR	618
Decreased customer consumption - weather and other	(2,141)
Other	(512)
Gross margin for the nine months ended September 30, 2016	$145,446

The following is a narrative discussion of the significant items, which we believe is necessary to understand the information disclosed in the foregoing table.

Service Expansions

Increased gross margin from natural gas service expansions was generated primarily from the following:

- $4.3 million attributable to $5.6 million from the short-term OPT ≤ 90 Service that commenced in December 2015 to an electric power generator in Kent County, Delaware and offset by a $1.3 million decrease in gross margin from the conclusion of the interruptible service Eastern Shore provided this customer in 2015. The short-term OPT ≤ 90 Service is expected to be replaced by a 20-year OPT ≤ 90 Service in the first quarter of 2017.
- $744,000 from short-term firm service that commenced in March 2016, following certain measurement and related improvements to Eastern Shore's interconnect with TETLP that increased its natural gas receipt capacity from TETLP by 53,000 Dts/d, for a total capacity of 160,000 Dts/d. This service will generate approximately $1.4 million in additional gross margin in 2016. The remaining capacity is available for firm or interruptible service.
- $720,000 from natural gas transmission service as part of the major expansion initiative in Polk County, Florida.

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- The foregoing gross margin increases were offset by a gross margin decrease of $243,000 resulting from a reduction in rates for a long-term firm service to an industrial customer in New Castle County, Delaware.

Additional Revenue from GRIP in Florida

Additional GRIP investments during 2015 and 2016 by our Florida natural gas distribution operations generated $3.1 million in additional gross margin during the first nine months of 2016, compared to the same period in 2015.

Natural Gas Growth (excluding service expansions)

Increased gross margin from other growth in natural gas (excluding service expansions) was generated primarily from the following:

- $1.1 million from a 3.5 percent increase in the average number of residential customers in the Delmarva natural gas distribution operations, as well as growth in the number of commercial and industrial customers.
- $1.1 million from Florida natural gas customer growth due primarily to new services to commercial and industrial customers.
- $348,000 from Eastern Shore interruptible service provided to other customers.

Implementation of Delaware Division Interim Rates

Our Delaware Division generated additional gross margin of $1.4 million from the implementation of interim rates as a result of its rate case filing, during the first nine months of 2016. See Note 4, Rates and Other Regulatory Activities, to the condensed consolidated financial statements for additional details.

Margin from service to Eight Flags

We generated additional gross margin of $892,000 from new natural gas transmission and distribution services provided to our Eight Flags' CHP plant, commencing in June of 2016.

Sandpiper SIR Rates

Sandpiper generated additional gross margin of $618,000 from a higher system improvement rate resulting from the continuing conversion of the Sandpiper system from propane service to natural gas service.

Decreased Customer Consumption - Weather and Other

The above increases were partially offset by $2.1 million in lower gross margin due to reduced consumption of natural gas and electricity, largely as a result of warmer weather during the first quarter of 2016, compared to the same period in 2015.

Other Operating Expenses

Other operating expenses increased by $6.4 million. The significant components of the increase in other operating expenses included:

- $2.0 million in higher payroll and benefits costs for additional personnel to support growth;
- $1.4 million due to the absence of a $1.5 million gain from a customer billing system settlement, recorded in 2015, which was partially offset by an associated gain of $130,000 during the third quarter of 2016, representing an additional current portion of the contingent settlement recovery;
- $1.4 million in higher depreciation, asset removal and property tax costs associated with recent capital investments to support growth and system integrity; and
- $817,000 in higher outside services costs primarily associated with growth and ongoing compliance activities.

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Unregulated Energy Segment

For the quarter ended September 30, 2016 compared to the quarter ended September 30, 2015

	Three Months Ended September 30,		Increase
	2016	2015	(decrease)
(in thousands)			
Revenue	$42,042	$29,609	$12,433
Cost of sales	31,840	19,402	12,438
Gross margin	10,202	10,207	(5)
Operations & maintenance	10,975	9,305	1,670
Depreciation & amortization	1,840	1,483	357
Other taxes	467	441	26
Other operating expenses	13,282	11,229	2,053
Operating Loss	$(3,080)	$(1,022)	$(2,058)

Operating loss for the Unregulated Energy segment for the quarter ended September 30, 2016 was $3.1 million, an increase of $2.1 million compared to the same quarter of 2015. The Unregulated Energy segment typically reports an operating loss in the third quarter due to the seasonal nature the businesses included in this segment. Gross margin for the quarter was $10.2 million, which was more than offset by operating expenses of $13.3 million, to generate the operating loss of $3.1 million.

Gross Margin

Items contributing to the quarter-over-quarter decrease of $5,000 in gross margin are listed in the following table:

(in thousands)	
Gross margin for the three months ended September 30, 2015	$10,207
Factors contributing to the gross margin decrease for the three months ended September 30, 2016:	
Eight Flags	1,570
Aspire Energy	(407)
Lower margins for Xeron	(413)
Decreased retail propane margins	(414)
Other	(341)
Gross margin for the three months ended September 30, 2016	$10,202

The following is a discussion of the significant items, which we believe is necessary to understand the information disclosed in the foregoing table.

Eight Flags

Eight Flags' CHP plant, which commenced operations in June 2016, generated $1.6 million in additional gross margin.

Aspire Energy

$407,000 of decreased gross margin from Aspire Energy as a result of increased deliveries and imbalance positions that favorably impacted Aspire Energy in the third quarter of 2015, which are non-recurring. Lower margin associated with system volumes and imbalance positions in third quarter of 2016, also contributed to the decrease.

Lower Margins for Xeron

Xeron's gross margin decreased by $413,000 resulting from lower margins on executed trades.

Decreased Retail Propane Margins
Lower retail propane margins for our Delmarva and Florida propane distribution operations decreased gross margin by $414,000, of which $344,000 is associated with the Delmarva Peninsula propane distribution operation, as retail margins per gallon returned

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to more normal levels; accordingly, we have continued to assume more normal levels of margins in our long-term financial plans and forecasts. The decline in margin was driven principally by lower propane prices and local market conditions. The level of retail margins per gallon generated during 2015 were not expected to be sustained over the long term.

Other Operating Expenses

Other operating expenses increased by $2.1 million. The significant components of the increase in other operating expenses included:

- $1.1 million in other operating expenses incurred by the Eight Flags CHP plant;
- $545,000 in higher payroll and benefits costs for additional personnel to support growth; and
- $225,000 in higher outside services costs primarily associated with growth and ongoing compliance activities.

For the nine months ended September 30, 2016 compared to the nine months ended September 30, 2015

	Nine Months Ended September 30,		Increase
	2016	2015	(decrease)
(in thousands)			
Revenue	$136,361	123,164	$13,197
Cost of sales	90,981	77,235	13,746
Gross margin	45,380	45,929	(549)
Operations & maintenance	30,136	26,993	3,143
Depreciation & amortization	4,512	3,973	539
Other taxes	1,465	1,297	168
Other operating expenses	36,113	32,263	3,850
Operating Income	$9,267	$13,666	$(4,399)

Operating income for the Unregulated Energy segment for the nine months ended September 30, 2016 was $9.3 million, a decrease of $4.4 million, or 32.2 percent for the same period of 2015. The results for the first nine months include an increase in gross margin of $4.5 million and other operating expenses of $2.5 million, each associated with Aspire Energy. Excluding these impacts from Aspire Energy, gross margin decreased by $5.1 million, and other operating expenses increased by $1.4 million.

Gross Margin

Items contributing to the period-over-period decrease of $549,000 in gross margin are listed in the following table:

(in thousands)	
Gross margin for the nine months ended September 30, 2015	$45,929
Factors contributing to the gross margin decrease for the nine months ended September 30, 2016:	
Aspire Energy	4,542
Eight Flags	1,689
Natural gas marketing	1,062
Lower margins for Xeron	(419)
Decreased wholesale propane sales	(436)
Decreased retail propane margins	(2,204)
Decreased customer consumption - weather and other	(4,059)
Other	(724)
Gross margin for the nine months ended September 30, 2016	$45,380

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The following is a discussion of the significant items, which we believe is necessary to understand the information disclosed in the foregoing table.

Aspire Energy
Aspire Energy generated $8.2 million in gross margin compared to $3.7 million in the same period of 2015, an increase of $4.5 million. Results for the first nine months of 2015 reflect only six months of margin for Aspire Energy, which became a wholly-owned subsidiary of Chesapeake Utilities on April 1, 2015. In addition, Aspire Energy generated additional margins as a result of pricing amendments to long-term gas sales agreements, additional management fees and the optimization of gathering system receipts and deliveries.

Eight Flags
Eight Flags' CHP plant, which commenced operations in June 2016, generated $1.7 million in additional gross margin.

Natural Gas Marketing
PESCO generated $1.1 million in additional gross margin due to customer growth and the positive impact from favorable supply management and hedging activities, which generated additional gross margin.

Lower Margins for Xeron
Xeron's gross margin decreased by $419,000 resulting from lower margins on executed trades.

Decreased Propane Wholesale Sales
Gross margin decreased by $436,000 as a result of lower propane wholesale sales associated with the supply agreement between an affiliate of ESG and Sandpiper Energy. The lower sales are expected as more customers in Ocean City, Maryland and surrounding areas are converted from propane to natural gas. Lower sales due to significantly warmer weather in the first nine months of 2016 compared to the same period in 2015, also contributed to this decrease.

Decreased Retail Propane Margins
Lower retail propane margins for our Delmarva propane distribution operation decreased gross margin by $2.2 million, as margins per retail gallon returned to more normal levels. The decline in margin was driven principally by lower propane prices and local market conditions. The level of retail margins per gallon generated during 2015 were not expected to be sustained over the long term; accordingly, we have continued to assume more normal levels of margins in our long-term financial plans and forecasts.
This decrease was partially offset by $61,000 in higher retail propane margins per gallon for our Florida propane distribution operation as a result of local market conditions.

Decreased Customer Consumption - Weather and Other
Gross margin decreased by $4.1 million due to lower customer consumption of propane. The decrease was driven mainly by weather as a result of warmer temperatures on the Delmarva Peninsula during the first nine months of 2016 compared to colder temperatures during the first nine months of 2015.

Other Operating Expenses
Other operating expenses increased by $3.9 million. The significant components of the increase in other operating expenses included:

- $2.5 million in other operating expenses incurred by Aspire Energy, given the additional quarter's results included in 2016, compared to only six months of results in the nine months ended September 30, 2015; and
- $1.1 million in other operating expenses incurred by Eight Flags, which commenced operations in June 2016.

Interest Charges

For the quarter ended September 30, 2016 compared to the quarter ended September 30, 2015

Interest charges for the three months ended September 30, 2016 increased by approximately $230,000, compared to the same quarter in 2015, attributable to an increase of $392,000 in interest from higher short-term borrowings, partially offset by a decrease of $117,000 in interest from long-term debt.

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For the nine months ended September 30, 2016 compared to the nine months ended September 30, 2015
Interest charges for the nine months ended September 30, 2016 increased by approximately $571,000, compared to the same period in 2015, attributable to an increase of $1.1 million in interest from higher short-term borrowings, partially offset by a decrease of $352,000 in interest from long-term debt.

Income Taxes
For the quarter ended September 30, 2016 compared to the quarter ended September 30, 2015
Income tax expense was $3.0 million in the third quarter of 2016, compared to $3.3 million in the same quarter in 2015. The slight decrease in income tax expense was due primarily to lower taxable income. Our effective income tax rate was 40.4 percent and 39.4 percent, for the third quarter of 2016 and 2015, respectively.

For the nine months ended September 30, 2016 compared to the nine months ended September 30, 2015
Income tax expense was $21.4 million in the nine months ended September 30, 2016, compared to $21.6 million in the same period in 2015. The slight decrease in income tax expense was due primarily to lower taxable income. Our effective income tax rate was 39.5 percent and 40.0 percent, for the first nine months of 2016 and 2015, respectively.

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FINANCIAL POSITION, LIQUIDITY AND CAPITAL RESOURCES

Our capital requirements reflect the capital-intensive and seasonal nature of our business and are principally attributable to investment in new plant and equipment, retirement of outstanding debt and seasonal variability in working capital. We rely on cash generated from operations, short-term borrowings, and other sources to meet normal working capital requirements and to temporarily finance capital expenditures. We may also issue long-term debt and equity to fund capital expenditures and to more closely align our capital structure to target.

Our energy businesses are weather-sensitive and seasonal. We normally generate a large portion of our annual net income and subsequent increases in our accounts receivable in the first and fourth quarters of each year due to significant volumes of natural gas, electricity, and propane delivered to customers through our natural gas, electric, and propane distribution operations and our natural gas gathering and processing operation during the peak heating season. In addition, our natural gas and propane inventories, which usually peak in the fall months, are largely drawn down in the heating season and provide a source of cash as the inventory is used to satisfy winter sales demand.

Our capital expenditures for the nine months ended September 30, 2016 were approximately $106.3 million. We currently project aggregate capital expenditures between $150.0 and $170.0 million in 2016. Our current forecast by segment and business line is shown below:

	Low	High
(dollars in thousands)		
Regulated Energy:		
Natural gas distribution	$60,000	$65,000
Natural gas transmission	55,000	60,000
Electric distribution	10,000	13,000
Total Regulated Energy	125,000	138,000
Unregulated Energy:		
Propane distribution	10,000	12,000
Other unregulated energy	10,000	13,000
Total Unregulated Energy	20,000	25,000
Other	5,000	7,000
Total 2016 capital expenditures	$150,000	$170,000

The 2016 forecast includes expenditures for the following projects: Eight Flags' CHP plant; anticipated new facilities to serve an electric power generator in Kent County, Delaware under the OPT ≤ 90 Service; Eastern Shore's system reliability project; additional expansions of our natural gas distribution and transmission systems; continued natural gas infrastructure improvement activities; expenditures for continued replacement under the Florida GRIP; replacement of several facilities and information technology systems; and other strategic initiatives and investments.

Actual capital requirements may vary from the above estimates due to a number of factors, including changing economic conditions, customer growth in existing areas, regulation, new growth or acquisition opportunities and availability of capital. Historically, actual capital expenditures have typically lagged behind the budgeted amounts. The timing of capital expenditures can vary based on securing environmental approvals and other permits. The regulatory application and approval process has lengthened, and we expect this trend to continue.

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Capital Structure

We are committed to maintaining a sound capital structure and strong credit ratings to provide the financial flexibility needed to access capital markets when required. This commitment, along with adequate and timely rate relief for our regulated operations, is intended to ensure our ability to attract capital from outside sources at a reasonable cost. We believe that the achievement of these objectives will provide benefits to our customers, creditors and investors. The following table presents our capitalization, excluding and including short-term borrowings, as of September 30, 2016 and December 31, 2015:

(in thousands)	September 30, 2016		December 31, 2015	
Long-term debt, net of current maturities	$143,525	25 %	$149,006	29 %
Stockholders' equity	438,300	75 %	358,138	71 %
Total capitalization, excluding short-term debt	$581,825	100%	$507,144	100%

(in thousands)	September 30, 2016		December 31, 2015	
Short-term debt	$154,490	20 %	$173,397	25 %
Long-term debt, including current maturities	155,612	21 %	158,157	23 %
Stockholders' equity	438,300	59 %	358,138	52 %
Total capitalization, including short-term debt	$748,402	100%	$689,692	100%

Included in the long-term debt balances at September 30, 2016 and December 31, 2015, was a capital lease obligation associated with Sandpiper's capacity, supply and operating agreement ($2.4 million and $3.5 million, respectively, net of current maturities, and $3.8 million and $4.8 million, respectively, including current maturities). Sandpiper entered into this six-year agreement at the closing of the ESG acquisition in May 2013. The capacity portion of this agreement is accounted for as a capital lease.

Our target ratio of equity to total capitalization, including short-term borrowings, is between 50 and 60 percent. On September 22, 2016, we completed a public offering of 960,488 shares of our common stock at a price per share of $62.26. The net proceeds from the sale of common stock, after deducting underwriting commissions and expenses, were approximately $57.3 million, which were added to our general funds and used primarily to repay a portion of our short-term debt under unsecured lines of credit. The issuance of equity resulted in our equity to total capitalization ratio representing 59% as of September 30, 2016.

As described below under "Short-term Borrowings," we entered into the Credit Agreement and the Revolver with the Lenders on October 8, 2015, which increased our borrowing capacity by $150.0 million. To facilitate the refinancing of a portion of the short-term borrowings into long-term debt, as appropriate, we also entered into a long-term Shelf Agreement with Prudential for the potential private placement of Shelf Notes as further described below under the heading "Shelf Agreement."

For larger capital projects, to the extent feasible, we will seek to align any planned long-term debt or equity issuances with the earnings associated with the commencement of long-term service for larger revenue-generating capital projects. The exact timing of any long-term debt or equity issuances will be based on market conditions.

Short-term Borrowings

Our outstanding short-term borrowings at September 30, 2016 and December 31, 2015 were $154.5 million and $173.4 million, respectively. The weighted average interest rates for our short-term borrowings were 1.49 percent and 1.09 percent, for the nine months ended September 30, 2016 and 2015, respectively.

We utilize bank lines of credit to provide funds for our short-term cash needs to meet seasonal working capital requirements and to temporarily fund portions of the capital expenditure program. As of September 30, 2016, we had four unsecured bank credit facilities with three financial institutions totaling $170.0 million in total available credit. In addition, since October 2015, we have $150.0 million of additional short-term debt capacity available under the Revolver with five participating Lenders. The terms of the Revolver are described in further detail below. We also had access to two credit facilities with a total of $40.0 million of available credit. The Revolver replaced these credit facilities when they expired on October 31, 2015. None of the unsecured bank lines of credit requires compensating balances. We are currently authorized by our Board of Directors to borrow up to $275.0 million of short-term borrowing.

The $150.0 million Revolver has a five-year term and is subject to the terms and conditions set forth in the Credit Agreement. Borrowings under the Revolver will be used for general corporate purposes, including repayments of short-term borrowings, working capital requirements and capital expenditures. Borrowings under the Revolver will bear interest at: (i) the LIBOR Rate plus an applicable margin of 1.25 percent or less, with such margin based on total indebtedness as a percentage of total capitalization, both as defined by the Credit Agreement, or (ii) the base rate plus 0.25% or less. Interest is payable quarterly, and the Revolver is subject to a commitment fee on the unused portion of the facility. We have the right, under certain circumstances, to extend the expiration date for up to two years on any anniversary date of the Revolver, with such extension subject to the Lenders' approval. We may also request the Lenders to increase the Revolver to $200.0 million, with any increase at the sole discretion of each Lender. At September 30, 2016 and December 31, 2015, we had outstanding borrowings of $50.0 million and $35.0 million, respectively, under the Revolver.

Shelf Agreement

On October 8, 2015, we entered into a Shelf Agreement with Prudential. Under the terms of the Shelf Agreement, through October 8, 2018, we may request that Prudential purchase up to $150.0 million of our Shelf Notes at a fixed interest rate and with a maturity date not to exceed 20 years from the date of issuance. Prudential is under no obligation to purchase any of the Shelf Notes. The interest rate and terms of payment of any series of Shelf Notes will be determined at the time of purchase. We currently anticipate the proceeds from the sale of any series of Shelf Notes will be used for general corporate purposes, including refinancing of short-term borrowing and/or repayment of outstanding indebtedness and financing capital expenditures on future projects; however, actual use of such proceeds will be determined at the time of a purchase.

On May 13, 2016, we submitted a request that Prudential purchase $70.0 million of 3.25 percent Shelf Notes under the Shelf Agreement. On May 20, 2016, Prudential accepted and confirmed our request. The proceeds received from the issuances of the Shelf Notes will be used to reduce short-term borrowings under the Company’s revolving credit facility, lines of credit and/or to fund capital expenditures. The closing of the sale and issuance of the Shelf Notes is expected to occur on or before April 28, 2017.

The Shelf Agreement sets forth certain business covenants to which we are subject when any Shelf Note is outstanding, including covenants that limit or restrict our ability, and the ability of our subsidiaries, to incur indebtedness, place or permit liens and encumbrances on any of our property or the property of our subsidiaries.

Cash Flows

The following table provides a summary of our operating, investing and financing cash flows for the nine months ended September 30, 2016 and 2015:

	Nine Months Ended September 30,	
	2016	2015
(in thousands)		
Net cash provided by (used in):		
Operating activities	$82,225	$93,932
Investing activities	(106,992)	(118,233)
Financing activities	23,448	23,508
Net decrease in cash and cash equivalents	(1,319)	(793)
Cash and cash equivalents—beginning of period	2,855	4,574
Cash and cash equivalents—end of period	$1,536	$3,781

Cash Flows Provided By Operating Activities

Changes in our cash flows from operating activities are attributable primarily to changes in net income, non-cash adjustments for depreciation, deferred income taxes and working capital. Changes in working capital are determined by a variety of factors, including weather, the prices of natural gas, electricity and propane, the timing of customer collections, payments for purchases of natural gas, electricity and propane, and deferred fuel cost recoveries.

During the nine months ended September 30, 2016 and 2015, net cash provided by operating activities was $82.2 million and $93.9 million, respectively, resulting in a decrease in cash flows of $11.7 million. Significant operating activities generating the cash flows change were as follows:

- Net income, adjusted for reconciling activities, increased cash flows by $15.4 million, due primarily to an increase in deferred income taxes as a result of the availability and utilization of bonus depreciation in the first nine months of 2016, which resulted in a higher book-to-tax timing difference and higher non-cash adjustments for depreciation and amortization.

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- Changes in net regulatory assets and liabilities decreased cash flows by $9.8 million, due primarily to changes in fuel costs collected through the various fuel cost recovery mechanisms.
- Changes in net accounts receivable and accrued revenue and accounts payable and accrued liabilities decreased cash flows by $12.2 million, due primarily to higher revenues and the timing of the receipt of customer payments as well as increased operating expenses and the timing of payments to vendors.
- Changes in propane, natural gas and materials inventories decreased net cash flows by approximately $5.3 million.

Cash Flows Used in Investing Activities

Net cash used in investing activities totaled $107.0 million and $118.2 million during the nine months ended September 30, 2016 and 2015, respectively, resulting in an increase in cash flows of $11.2 million. This was due primarily to the $20.7 million net cash ($27.5 million cash paid, less $6.8 million of cash acquired) used for the Gatherco acquisition in 2015. An increase in capital investments of $9.7 million partially offset this decrease.

Cash Flows Provided by Financing Activities

Net cash provided by financing activities totaled $23.4 million in the first nine months of both 2016 and 2015. Net proceeds of $57.3 million, after deducting underwriting commissions and expenses, from the issuance of common stock during the third quarter of 2016, was used to pay down short-term debt. Net cash provided by financing activities further increased as a result of an increase in a cash overdraft of $2.5 million and an increase in short-term borrowing of $35.9 million, partially offset by common stock dividends of $13.0 million and $600,000 of stock issued for the Dividend Reinvestment Plan. During the nine months ended September 30, 2015, there were approximately $31.6 million in net additional borrowings, offset by common stock dividends of $11.7 million and $633,000 of stock issued for the Dividend Reinvestment Plan.

Off-Balance Sheet Arrangements

We have issued corporate guarantees to certain vendors of our subsidiaries, primarily Xeron and PESCO, which provide for the payment of propane and natural gas purchases in the event that the subsidiary defaults. Neither subsidiary has ever defaulted on its obligations to pay its suppliers. The liabilities for these purchases are recorded in our financial statements when incurred. The aggregate amount guaranteed at September 30, 2016 was $53.9 million, with the guarantees expiring on various dates through September 2017.

We have issued letters of credit totaling $8.4 million related to the electric transmission services for FPU's northwest electric division, the firm transportation service agreement between TETLP and our Delaware and Maryland divisions, and to our current and previous primary insurance carriers. These letters of credit have various expiration dates through September 2017. There have been no draws on these letters of credit as of September 30, 2016. We do not anticipate that the letters of credit will be drawn upon by the counterparties, and we expect that they will be renewed to the extent necessary in the future. Additional information is presented in Item 1, Financial Statements, Note 6, Other Commitments and Contingencies in the Condensed Consolidated Financial Statements.

Contractual Obligations

There has been no material change in the contractual obligations presented in our 2015 Annual Report on Form 10-K, except for commodity purchase obligations and forward contracts entered into in the ordinary course of our business. The following table summarizes commodity and forward contract obligations at September 30, 2016:

	Payments Due by Period				
	Less than 1 year	1 - 3 years	3 - 5 years	More than 5 years	Total
(in thousands)					
Purchase obligations - Commodity [1]	$42,155	$ 3,417	$ —	$ —	$45,572

[1] In addition to the obligations noted above, we have agreements with commodity suppliers that have provisions with no minimum purchase requirements. There are no monetary penalties for reducing the amounts purchased; however, the propane contracts allow the suppliers to reduce the amounts available in the winter season if we do not purchase specified amounts during the summer season. Under these contracts, the commodity prices will fluctuate as market prices fluctuate.

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Rates and Regulatory Matters
Our natural gas distribution operations in Delaware, Maryland and Florida and electric distribution operation in Florida are subject to regulation by the respective state PSC; Eastern Shore is subject to regulation by the FERC; and Peninsula Pipeline is subject to regulation by the Florida PSC. At September 30, 2016, we were involved in regulatory matters in each of the jurisdictions in which we operate. Our significant regulatory matters are fully described in Note 4, Rates and Other Regulatory Activities, to the unaudited condensed consolidated financial statements in this Quarterly Report on Form 10-Q.
Recent Authoritative Pronouncements on Financial Reporting and Accounting
Recent accounting developments applicable to us and their impact on our financial position, results of operations and cash flows are described in Note 1, Summary of Accounting Policies, to the unaudited condensed consolidated financial statements in this Quarterly Report on Form 10-Q.

Item 3. Quantitative and Qualitative Disclosures about Market Risk
Market risk represents the potential loss arising from adverse changes in market rates and prices. Long-term debt is subject to potential losses based on changes in interest rates. Our long-term debt consists of fixed-rate senior notes and secured debt. All of our long-term debt, excluding a capital lease obligation, is fixed-rate debt and was not entered into for trading purposes. The carrying value of our long-term debt, including current maturities, but excluding a capital lease obligation, was $151.8 million at September 30, 2016, as compared to a fair value of $173.5 million, using a discounted cash flow methodology that incorporates a market interest rate based on published corporate borrowing rates for debt instruments with similar terms and average maturities, with adjustments for duration, optionality, credit risk, and risk profile. We evaluate whether to refinance existing debt or permanently refinance existing short-term borrowing, based in part on the fluctuation in interest rates.

Our propane distribution business is exposed to market risk as a result of our propane storage activities and entering into fixed price contracts for supply. We can store up to approximately 6.8 million gallons of propane (including leased storage and rail cars) during the winter season to meet our customers’ peak requirements and to serve metered customers. Decreases in the wholesale price of propane may cause the value of stored propane to decline. To mitigate the impact of price fluctuations, we have adopted a Risk Management Policy that allows the propane distribution operation to hedge its inventory.

In 2016, PESCO entered into a SCO supplier agreement with Columbia Gas to provide natural gas supply for Columbia Gas to service one of its local distribution customer tranches. PESCO also assumed the obligation to store natural gas inventory to satisfy its obligations under the SCO supplier agreement, which terminates on March 31, 2017. In conjunction with the SCO supplier agreement, PESCO entered into natural gas futures contracts during the second quarter of 2016 in order to protect its natural gas inventory against market price fluctuations.
Our propane wholesale marketing operation is a party to propane and crude oil futures and forward contracts, with various third parties, which require that the propane wholesale marketing operation purchase or sell natural gas liquids or crude oil at a fixed price at fixed future dates. At expiration, the contracts are typically settled financially without taking physical delivery of propane or crude oil. The propane wholesale marketing operation also enters into futures contracts that are traded on the Intercontinental Exchange, Inc. In certain cases, the futures contracts are settled by the payment or receipt of a net amount equal to the difference between the current market price of the futures contract and the original contract price; however, they may also be settled by physical receipt or delivery of propane or crude oil. The forward and futures contracts are entered into for trading and wholesale marketing purposes. The propane wholesale marketing business is subject to commodity price risk on its open positions to the extent that market prices for natural gas liquids deviate from fixed contract settlement prices. Market risk associated with the trading of futures and forward contracts is monitored daily for compliance with our Risk Management Policy, which includes dollar limits for open positions. To manage exposures to changing market prices, open positions are marked up or down to market prices and reviewed daily by our oversight officials. In addition, the Risk Management Committee reviews periodic reports on markets and the credit risk of counter-parties, approves any exceptions to the Risk Management

Policy (within limits established by the Board of Directors) and authorizes the use of any new types of contracts. As of September 30, 2016, there were no outstanding contracts.
We have entered into agreements with various suppliers to purchase natural gas, electricity and propane for resale to our customers. Purchases under these contracts either do not meet the definition of derivatives or are considered "normal purchases and sales" and are accounted for on an accrual basis.

At September 30, 2016 and December 31, 2015, we marked these forward and other contracts to market, using market transactions in either the listed or OTC markets, which resulted in the following assets and liabilities:

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(in thousands)	September 30, 2016	December 31, 2015
Mark-to-market energy assets, including call options, swap agreements and futures	$ 477	$ 153
Mark-to-market energy liabilities, including swap agreements and futures	$ 29	$ 433

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Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

The Chief Executive Officer and Chief Financial Officer of Chesapeake Utilities, with the participation of other Company officials, have evaluated our “disclosure controls and procedures” (as such term is defined under Rules 13a-15(e) and 15d-15(e), promulgated under the Securities Exchange Act of 1934, as amended) as of September 30, 2016. Based upon their evaluation, the Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of September 30, 2016.

Changes in Internal Control over Financial Reporting

During the quarter ended September 30, 2016, there was no change in our internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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PART II—OTHER INFORMATION

Item 1. Legal Proceedings

As disclosed in Note 6, Other Commitments and Contingencies, of the unaudited condensed consolidated financial statements in this Quarterly Report on Form 10-Q, we are involved in certain legal actions and claims arising in the normal course of business. We are also involved in certain legal and administrative proceedings before various governmental or regulatory agencies concerning rates and other regulatory actions. In the opinion of management, the ultimate disposition of these proceedings and claims will not have a material effect on our condensed consolidated financial position, results of operations or cash flows.

Item 1A. Risk Factors

Our business, operations, and financial condition are subject to various risks and uncertainties. The risk factors described in Part I, "Item 1A. Risk Factors" in our Annual Report on Form 10-K, for the year ended December 31, 2015, should be carefully considered, together with the other information contained or incorporated by reference in this Quarterly Report on Form 10-Q and in our other filings with the SEC in connection with evaluating Chesapeake Utilities, our business and the forward-looking statements contained in this Quarterly Report on Form 10-Q. Additional risks and uncertainties not known to us at present, or that we currently deem immaterial, also may affect Chesapeake Utilities. The occurrence of any of these known or unknown risks could have a material adverse impact on our business, financial condition and results of operations.

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

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs (2)	Maximum Number of Shares That May Yet Be Purchased Under the Plans or Programs (2)
July 1, 2016 through July 30, 2016 (1)	366	$ 66.35	—	—
August 1, 2016 through August 31, 2016	—	$ —	—	—
September 1, 2016 through September 30, 2016	—	$ —	—	—
Total	366	$ 66.35	—	—

(1) Chesapeake Utilities purchased shares of stock on the open market for the purpose of reinvesting the dividend on deferred stock units held in the Rabbi Trust accounts for certain Directors and Senior Executives under the Deferred Compensation Plan. The Deferred Compensation Plan is discussed in detail in Item 8 under the heading "Notes to the Consolidated Financial Statements—Note 16, Employee Benefit Plans" in our latest Annual Report on Form 10-K for the year ended December 31, 2015. During the quarter ended September 30, 2016, 366 shares were purchased through the reinvestment of dividends on deferred stock units.

(2) Except for the purposes described in Footnote (1), Chesapeake Utilities has no publicly announced plans or programs to repurchase its shares.

Item 3. Defaults upon Senior Securities

None.

Item 5. Other Information

None.

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Item 6. Exhibits

1.1	Underwriting Agreement entered into by Chesapeake Utilities Corporation and Wells Fargo Securities, LLC, RBC Capital Markets, LLC, Janney Montgomery Scott LLC., Robert W. Baird & Co., Incorporated, J.J.B. Hilliard, W.L. Lyons, LLC, Ladenburg Thalmann & Co. Inc., U.S. Capital Advisors LLC and BB&T Securities, LLC on September 22, 2016, relating to the sale and issuance of 835,207 shares of the Company's common stock, is incorporated herein by reference to Exhibit 1.1 of the Company's current report on Form 8-K, filed on September 28, 2016, File No. 001-11590.
3.3	Second Amendment to the Amended and Restated Bylaws of Chesapeake Utilities Corporation, effective November 2, 2016, is filed herewith.
31.1	Certificate of Chief Executive Officer of Chesapeake Utilities Corporation pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934.
31.2	Certificate of Chief Financial Officer of Chesapeake Utilities Corporation pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934.
32.1	Certificate of Chief Executive Officer of Chesapeake Utilities Corporation pursuant to 18 U.S.C. Section 1350.
32.2	Certificate of Chief Financial Officer of Chesapeake Utilities Corporation pursuant to 18 U.S.C. Section 1350.
101.INS*	XBRL Instance Document.
101.SCH*	XBRL Taxonomy Extension Schema Document.
101.CAL*	XBRL Taxonomy Extension Calculation Linkbase Document.
101.DEF*	XBRL Taxonomy Extension Definition Linkbase Document.
101.LAB*	XBRL Taxonomy Extension Label Linkbase Document.
101.PRE*	XBRL Taxonomy Extension Presentation Linkbase Document.

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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.

CHESAPEAKE UTILITIES CORPORATION

/S/ BETH W. COOPER
Beth W. Cooper
Senior Vice President and Chief Financial Officer
Date: November 3, 2016