

NEW PEOPLES BANKSHARES INC

Form 10-Q

May 10, 2010

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

**FORM 10-Q**

x **Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**  
For the quarterly period ended March 31, 2010

.. **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: 000-33411

**NEW PEOPLES BANKSHARES, INC.**

(Exact name of registrant as specified in its charter)

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**Virginia**  
(State or other jurisdiction of  
incorporation or organization)

**31-1804543**  
(I.R.S. Employer  
Identification No.)

**67 Commerce Drive**

**Honaker, Virginia**  
(Address of principal executive offices)

**24260**  
(Zip Code)

**(276) 873-7000**  
(Registrant's telephone number, including area code)

**n/a**  
(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

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

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

Large accelerated filer  Accelerated filer   
Non-accelerated filer  Smaller reporting company   
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

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

10,009,037 shares of common stock, par value \$2.00 per share, outstanding as of May 5, 2010.

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**Table of Contents****Part I Financial Information****Item 1 Financial Statements****NEW PEOPLES BANKSHARES, INC.****CONSOLIDATED STATEMENTS OF INCOME****FOR THE THREE MONTHS ENDED MARCH 31, 2010 AND 2009**

(IN THOUSANDS EXCEPT SHARE AND PER SHARE DATA)

(UNAUDITED)

|  | 2010          | 2009          |
|--|---------------|---------------|
| <b>INTEREST AND DIVIDEND INCOME</b>                        |               |               |
| Loans including fees                                       | \$ 12,195     | \$ 12,340     |
| Federal funds sold   | 10            | 5             |
| Investments  | 44            | 61            |
| <b>Total Interest and Dividend Income</b>                  | <b>12,249</b> | <b>12,406</b> |
| <b>INTEREST EXPENSE</b>                                    |               |               |
| Deposits   |               |               |
| Demand   | 73            | 60            |
| Savings  | 200           | 311           |
| Time deposits  | 3,200         | 4,176         |
| FHLB Advances  | 261           | 261           |
| Line of credit borrowing                                   | 63            | 62            |
| Trust Preferred Securities                                 | 107           | 153           |
| <b>Total Interest Expense</b>                              | <b>3,903</b>  | <b>5,023</b>  |
| <b>NET INTEREST INCOME</b>                                 | <b>8,346</b>  | <b>7,383</b>  |
| <b>PROVISION FOR LOAN LOSSES</b>                           | <b>1,990</b>  | <b>418</b>    |
| <b>NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES</b> | <b>6,356</b>  | <b>6,965</b>  |
| <b>NONINTEREST INCOME</b>                                  |               |               |
| Service charges  | 610           | 549           |
| Fees, commissions and other income                         | 661           | 528           |
| Life insurance investment income                           | 106           | 100           |
| <b>Total Noninterest Income</b>                            | <b>1,377</b>  | <b>1,177</b>  |
| <b>NONINTEREST EXPENSES</b>                                |               |               |
| Salaries and employee benefits                             | 3,501         | 3,957         |
| Occupancy expense  | 1,067         | 1,031         |
| Other real estate expenses                                 | 142           | 109           |

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|  |               |               |
|--|---------------|---------------|
| FDIC insurance premiums                        | 750           | 197           |
| Computer software maintenance & licenses       | 240           | 190           |
| Other operating expenses                       | 1,451         | 1,365         |
| Total Noninterest Expenses                     | 7,152         | 6,849         |
| <b>INCOME BEFORE INCOME TAXES</b>              | <b>582</b>    | <b>1,293</b>  |
| <b>INCOME TAX EXPENSE</b>                      | <b>169</b>    | <b>387</b>    |
| <b>NET INCOME</b>                              | <b>\$ 413</b> | <b>\$ 906</b> |
| <b>Earnings Per Share</b>                      |               |               |
| Basic  | \$ 0.04       | \$ 0.09       |
| Fully Diluted                                  | \$ 0.04       | \$ 0.09       |
| <b>Average Weighted Shares of Common Stock</b> |               |               |
| Basic  | 10,009,037    | 10,008,902    |
| Fully Diluted                                  | 10,050,093    | 10,187,461    |

The accompanying notes are an integral part of this statement.

**Table of Contents****NEW PEOPLES BANKSHARES, INC.****CONSOLIDATED BALANCE SHEETS**

(IN THOUSANDS EXCEPT PER SHARE AND SHARE DATA)

|  | March 31,<br>2010<br>(Unaudited) | December 31,<br>2009<br>(Audited) |
|--|----------------------------------|-----------------------------------|
| <b>ASSETS</b>                          |                                  |                                   |
| Cash and due from banks                | \$ 33,729                        | \$ 29,978                         |
| Federal funds sold                     | 16,586                           | 9,582                             |
| Total Cash and Cash Equivalents        | 50,315                           | 39,560                            |
| Investment securities                  |                                  |                                   |
| Available-for-sale                     | 3,626                            | 2,606                             |
| Loans receivable                       | 758,364                          | 763,570                           |
| Allowance for loan losses              | (19,332)                         | (18,588)                          |
| Net Loans                              | 739,032                          | 744,982                           |
| Bank premises and equipment, net       | 35,351                           | 34,958                            |
| Equity securities (restricted)         | 4,014                            | 3,996                             |
| Other real estate owned                | 7,976                            | 5,643                             |
| Accrued interest receivable            | 4,541                            | 4,292                             |
| Life insurance investments             | 10,655                           | 10,549                            |
| Goodwill and other intangibles         | 4,441                            | 4,514                             |
| Deferred taxes                         | 5,400                            | 5,400                             |
| Other assets                           | 2,332                            | 1,410                             |
| Total Assets                           | \$ 867,683                       | \$ 857,910                        |
| <b>LIABILITIES</b>                     |                                  |                                   |
| Deposits:                              |                                  |                                   |
| Demand deposits:                       |                                  |                                   |
| Noninterest bearing                    | \$ 92,505                        | \$ 88,318                         |
| Interest-bearing                       | 54,693                           | 42,769                            |
| Savings deposits                       | 88,567                           | 90,467                            |
| Time deposits                          | 534,519                          | 539,160                           |
| Total Deposits                         | 770,284                          | 760,714                           |
| Federal Home Loan Bank advances        | 25,083                           | 25,383                            |
| Accrued interest payable               | 1,651                            | 1,617                             |
| Accrued expenses and other liabilities | 2,253                            | 2,181                             |
| Line of credit borrowing               | 4,900                            | 4,900                             |
| Trust preferred securities             | 16,496                           | 16,496                            |
| Total Liabilities                      | 820,667                          | 811,291                           |

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**STOCKHOLDERS EQUITY**

|   |            |            |
|---|------------|------------|
| Common stock - \$2.00 par value; 50,000,000 shares authorized; 10,009,037 shares issued and outstanding at March 31, 2010 and December 31, 2009, respectively | 20,018     | 20,018     |
| Additional paid-in-capital  | 21,683     | 21,683     |
| Retained earnings   | 5,303      | 4,890      |
| Accumulated other comprehensive income  | 12         | 28         |
| Total Stockholders Equity   | 47,016     | 46,619     |
| Total Liabilities and Stockholders Equity   | \$ 867,683 | \$ 857,910 |

The accompanying notes are an integral part of this statement.

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## NEW PEOPLES BANKSHARES, INC.

## CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY

## FOR THE THREE MONTHS ENDED MARCH 31, 2010 AND 2009

(IN THOUSANDS INCLUDING SHARE DATA)

(UNAUDITED)

|  | Shares<br>of<br>Common<br>Stock | Common<br>Stock | Additional<br>Paid in<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income<br>(Loss) | Total<br>Shareholders<br>Equity | Comprehensive<br>Income<br>(Loss) |
|--|---------------------------------|-----------------|----------------------------------|----------------------|---|---------------------------------|-----------------------------------|
| Balance, December 31, 2008                                       | 10,008                          | \$ 20,017       | \$ 21,683                        | \$ 8,576             | \$ 47   | \$ 50,323                       |                                   |
| Net Income   |                                 |                 |                                  | 906                  |   | 906                             | \$ 906                            |
| Unrealized loss on available-for-sale securities, net of \$4 tax |                                 |                 |                                  |                      | (12)  | (12)                            | (12)                              |
| Balance, March 31, 2009  | 10,008                          | \$ 20,017       | \$ 21,683                        | \$ 9,482             | \$ 35   | \$ 51,217                       | \$ 894                            |
| Balance, December 31, 2009                                       | 10,009                          | \$ 20,018       | \$ 21,683                        | \$ 4,890             | \$ 28   | \$ 46,619                       |                                   |
| Net Income   |                                 |                 |                                  | 413                  |   | 413                             | \$ 413                            |
| Unrealized loss on available-for-sale securities, net of \$8 tax |                                 |                 |                                  |                      | (16)  | (16)                            | (16)                              |
| Balance, March 31, 2010  | 10,009                          | \$ 20,018       | \$ 21,683                        | \$ 5,303             | \$ 12   | \$ 47,016                       | \$ 397                            |

The accompanying notes are an integral part of this statement.



**Table of Contents****NEW PEOPLES BANKSHARES, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS**

FOR THE THREE MONTHS ENDED MARCH 31, 2010 AND 2009

(IN THOUSANDS)

(UNAUDITED)

|   | 2010          | 2009             |
|---|---------------|------------------|
| <b>CASH FLOWS FROM OPERATING ACTIVITIES</b>                                       |               |                  |
| Net income  | \$ 413        | \$ 906           |
| Adjustments to reconcile net income to net cash provided by operating activities: |               |                  |
| Depreciation  | 686           | 711              |
| Provision for loan losses   | 1,990         | 418              |
| Income on life insurance, net   | (106)         | (83)             |
| Loss on sale of foreclosed real estate  | 4             | 14               |
| Amortization of core deposit intangible   | 73            | 44               |
| Net change in:  |               |                  |
| Interest receivable   | (249)         | (94)             |
| Other assets  | (922)         | 182              |
| Accrued expenses and other liabilities  | 106           | (354)            |
| <b>Net Cash Provided by Operating Activities</b>                                  | <b>1,995</b>  | <b>1,744</b>     |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES</b>                                       |               |                  |
| Net (increase) decrease in loans  | 1,397         | (15,845)         |
| Proceeds from sale and maturities of securities available-for-sale                | 69            | 1,034            |
| Purchase of securities available for sale   | (1,103)       |                  |
| Purchase of Federal Reserve Bank stock  | (19)          | (125)            |
| Sale of Federal Home Loan Bank stock  |               | 122              |
| Payments for the purchase of property   | (1,079)       | (530)            |
| Proceeds from sales of other real estate owned                                    | 225           | 392              |
| <b>Net Cash Used in Investing Activities</b>                                      | <b>(510)</b>  | <b>(15,344)</b>  |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES</b>                                       |               |                  |
| Repayments to Federal Home Loan Bank  | (300)         | (300)            |
| Net change in:  |               |                  |
| Demand and savings deposits   | 14,211        | (4,880)          |
| Time deposits   | (4,641)       | 17,793           |
| <b>Net Cash Provided by Financing Activities</b>                                  | <b>9,270</b>  | <b>12,613</b>    |
| <b>Net increase (decrease) in cash and cash equivalents</b>                       | <b>10,755</b> | <b>(987)</b>     |
| Cash and Cash Equivalents, Beginning of Period                                    | 39,560        | 23,912           |
| <b>Cash and Cash Equivalents, End of Period</b>                                   | <b>50,315</b> | <b>\$ 22,925</b> |

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### Supplemental Disclosure of Non Cash Transactions:

|  |          |          |
|--|----------|----------|
| Other real estate acquired in settlement of foreclosed loans | \$ 2,563 | \$ 1,330 |
| Loans made to finance sale of foreclosed real estate         | \$       | \$ 16    |

The accompanying notes are an integral part of this statement.

**Table of Contents****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****NOTE 1 NATURE OF OPERATIONS:**

New Peoples Bankshares, Inc. (the Company) is a bank holding company whose principal activity is the ownership and management of a community bank. New Peoples Bank, Inc. (the Bank) was organized and incorporated under the laws of the Commonwealth of Virginia on December 9, 1997. The Bank commenced operations on October 28, 1998, after receiving regulatory approval. As a state chartered bank, the Bank is subject to regulation by the Virginia Bureau of Financial Institutions and the Federal Deposit Insurance Corporation. In addition, as a member of the Federal Reserve System, the Bank and the Company are also subject to regulation by the Board of Governors of the Federal Reserve System. The Bank provides general banking services to individuals, small and medium size businesses and the professional community of southwestern Virginia, southern West Virginia, and eastern Tennessee. On June 9, 2003, the Company formed two wholly owned subsidiaries, NPB Financial Services, Inc. and NPB Web Services, Inc. In 2004 and 2006, the Company established NPB Capital Trust I and 2 respectively for the purpose of issuing trust preferred securities.

**NOTE 2 ACCOUNTING PRINCIPLES:**

The financial statements conform to U. S. generally accepted accounting principles and to general industry practices. In the opinion of management, the accompanying unaudited financial statements contain all adjustments (consisting of only normal recurring accruals) necessary to present fairly the financial position at March 31, 2010, and the results of operations for the three month periods ended March 31, 2010 and 2009. The notes included herein should be read in conjunction with the notes to financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2009. The results of operations for the three month periods ended March 31, 2010 and 2009 are not necessarily indicative of the results to be expected for the full year.

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

**NOTE 3 INVESTMENT SECURITIES:**

The amortized cost and estimated fair value of securities at the dates indicated are as follows:

| (Dollars are in thousands) | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|----------------------------|-------------------|------------------------------|-------------------------------|---------------|
| <b>March 31, 2010</b>      |                   |                              |                               |               |
| <u>Available for Sale</u>  |                   |                              |                               |               |
| U.S. Government Agencies   | \$ 1,999          | \$ 27                        | \$                            | \$ 2,026      |
| Mortgage backed securities | 714               | 4                            |                               | 718           |
| Taxable municipals         | 897               |                              | 15                            | 882           |
| Total Securities AFS       | \$ 3,610          | \$ 31                        | \$ 15                         | \$ 3,626      |
| <b>December 31, 2009</b>   |                   |                              |                               |               |
| <u>Available for Sale</u>  |                   |                              |                               |               |
| U.S. Government Agencies   | \$ 1,999          | \$ 38                        | \$                            | \$ 2,037      |
| Mortgage backed securities | 249               | 8                            |                               | 257           |
| Taxable municipals         | 317               |                              | 5                             | 312           |
| Total Securities AFS       | \$ 2,565          | \$ 46                        | \$ 5                          | \$ 2,606      |

At March 31, 2010 and December 31, 2009, all securities were classified as available for sale.

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The Bank, as a member of the Federal Reserve Bank and the Federal Home Loan Bank, is required to hold stock in each. These equity securities are restricted from trading and are recorded at a cost of \$4.0 million at March 31, 2010 and December 31, 2009, respectively.

**Table of Contents****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****NOTE 3 INVESTMENT SECURITIES (Continued):**

The amortized cost and fair value of investment securities at March 31, 2010, by contractual maturity, are shown in the following schedule. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

| (Dollars are in thousands)            | Amortized<br>Cost | Fair<br>Value | Weighted<br>Average<br>Yield |
|---------------------------------------|-------------------|---------------|------------------------------|
| <b>Securities Available for Sale</b>  |                   |               |                              |
| Due in one year or less               | 1,500             | 1,524         | 3.18%                        |
| Due after one year through five years | 691               | 702           | 3.03%                        |
| Due after five years                  | 1,419             | 1,400         | 4.64%                        |
| <br>Total                             | <br>\$ 3,610      | <br>\$ 3,626  | <br>3.73%                    |

Investment securities with a carrying value of \$900 thousand at March 31, 2010 and December 31, 2009, respectively, were pledged to secure public deposits and for other purposes required by law.

**NOTE 4 LOANS:**

Loans receivable outstanding are summarized as follows:

| (Dollars are in thousands)             | March 31,<br>2010 | December 31,<br>2009 |
|--|-------------------|----------------------|
| Commercial, financial and agricultural | \$ 120,168        | \$ 118,844           |
| Real estate construction               | 69,061            | 71,854               |
| Real estate mortgages                  | 501,576           | 504,071              |
| Installment loans to individuals       | 67,549            | 68,801               |
| <br>Total Loans                        | <br>\$ 758,354    | <br>\$ 763,570       |

The following is a summary of information at March 31, 2010 and December 31, 2009 pertaining to nonperforming assets:

| (Dollars are in thousands)                             | March 31,<br>2010 | December 31,<br>2009 |
|--|-------------------|----------------------|
| <b>Principal:</b>                                      |                   |                      |
| Nonaccrual loans                                       | \$ 25,446         | \$ 24,713            |
| Other real estate owned                                | 7,976             | 5,643                |
| Loans past due 90 days or more still accruing interest | 5,598             | 3,875                |
| <br>Total nonperforming assets                         | <br>\$ 39,020     | <br>\$ 34,231        |

The following table presents the Company's investment in loans considered to be impaired and related information on those impaired loans:

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| <b>(Dollars are in thousands)</b>                                    | <b>March 31,<br/>2010</b> | <b>December 31,<br/>2009</b> |
|--|---------------------------|------------------------------|
| Recorded investments in loans considered to be impaired              | \$ 37,428                 | \$ 30,138                    |
| Loans considered to be impaired that were on a non-accrual basis     | 25,446                    | 24,713                       |
| Recorded investment in impaired loans with related allowance         | 28,926                    | 26,063                       |
| Allowance for loan losses related to loans considered to be impaired | 10,704                    | 8,836                        |
| Average recorded investment in impaired loans                        | 33,783                    | 22,145                       |
| Recorded investment in impaired loans with no related allowance      | 8,501                     | 4,075                        |

Troubled debts restructured at March 31, 2010 were \$7.3 million as compared to none at December 31, 2009.

**Table of Contents****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****NOTE 5 ALLOWANCE FOR LOAN LOSSES:**

A summary of transactions in the allowance for loan losses is as follows:

| (Dollars are in thousands)      | For the Three Months Ended |                   |
|---------------------------------|----------------------------|-------------------|
|                                 | March 31,<br>2010          | March 31,<br>2009 |
| Balance, Beginning of Period    | \$ 18,588                  | \$ 6,904          |
| Provision for loan losses       | 1,990                      | 418               |
| Recoveries of loans charged off | 116                        | 50                |
| Loans charged off               | (1,362)                    | (251)             |
| <b>Balance, End of Period</b>   | <b>\$ 19,332</b>           | <b>\$ 7,121</b>   |
| Percentage of Loans             | 2.55%                      | 0.97%             |

**NOTE 6 EARNINGS PER SHARE:**

Basic earnings per share computations are based on the weighted average number of shares outstanding during each year. Dilutive earnings per share reflect the additional common shares that would have been outstanding if dilutive potential common shares had been issued. Potential common shares that may be issued relate to outstanding options and are determined by the Treasury method. Basic and diluted net income per common share calculations follows:

| (Amounts in Thousands, Except<br>Share and Per Share Data) | For the three months<br>ended March 31, |            |
|--|---|------------|
|  | 2010                                    | 2009       |
| Net income available to common shareholders                | \$ 413                                  | \$ 906     |
| Weighted average shares outstanding                        | 10,009,037                              | 10,008,902 |
| Dilutive shares for stock options                          | 41,156                                  | 178,559    |
| Weighted average dilutive shares outstanding               | 10,050,193                              | 10,187,461 |
| Basic earnings per share                                   | \$ 0.04                                 | \$ 0.09    |
| Diluted earnings per share                                 | \$ 0.04                                 | \$ 0.09    |

**NOTE 7 LINES OF CREDIT:**

In June 2008, the Company obtained a three year revolving line of credit totaling \$6.5 million from Silverton Bank collateralized by the common stock of the Bank. The current outstanding balance on the line is \$4.9 million. Due to the failure of Silverton Bank in May 2009, the remaining \$1.6 million no longer remains available for future use. Management is seeking financing to replace the line of credit in 2010. The revolving line of credit contains certain covenants related to debt coverage ratios and nonperforming assets of the Bank. At March 31, 2010, the Company remained in violation of the debt covenants regarding both debt coverage and asset quality. Failure to meet the financial covenants represents an event of default under the loan agreement which provides Silverton Bank, or the FDIC as its receiver in bankruptcy, with a number of remedies including those generally available to a lender under law or equity. The Company's Form 10-K for the period ended December 31, 2009 contains more detail about this loan.

The Bank has been asked by one of its correspondent banks, Compass Bank, to secure its \$5.0 million federal funds line of credit. Management anticipates doing this during the second quarter of 2010.

**NOTE 8 FAIR VALUE:**

ASC 820, Fair Value Measurements and Disclosures provides a framework for measuring fair value under generally accepted accounting principles and requires disclosures about the fair value of assets and liabilities recognized in the balance sheet in periods subsequent to initial recognition, whether the measurements are made on a recurring basis (for example, available for sale investment securities) or on a nonrecurring basis (for example, impaired loans and other real estate acquired through foreclosure).

Fair value is the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. Fair Value Measurements and Disclosures also establishes fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value:



**Table of Contents****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****NOTE 8 FAIR VALUE (CONTINUED):**

Level 1: Quoted prices in active markets for identical assets or liabilities. Level 1 assets and liabilities include debt and equity securities and derivative contracts that are traded in an exchange market, as well as U. S. Treasury, other U. S. Government and agency mortgage-backed debt securities that are highly liquid and are actively traded in over-the-counter markets.

Level 2: 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 2 assets and liabilities include debt securities with quoted prices that are traded less frequently than exchange-traded instruments and derivative contracts whose value is determined using a pricing model with inputs that are observable in the market or can be derived principally from or corroborated by observable market data. This category generally includes certain derivative contracts and impaired loans.

Level 3: Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets and liabilities. Level 3 assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which the determination of fair value requires significant management judgment or estimation. For example, this category generally includes certain private equity investments, retained residual interests in securitizations, residential mortgage servicing rights, and highly structured or long-term derivative contracts.

*Investment Securities Available for Sale* Investment securities available for sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted prices. The Company's available for sale securities, totaling \$3.6 million at March 31, 2010, are the only assets whose fair values are measured on a recurring basis using Level 2 inputs from an independent pricing service.

*Loans* The Company does not record loans at fair value on a recurring basis. The Company is predominantly an asset based lender with real estate serving as collateral on a substantial majority of loans. From time to time a loan is considered impaired and an allowance for loan losses is established. Loans which are deemed to be impaired are primarily valued on a nonrecurring basis at the fair values of the underlying real estate collateral. Such fair values are obtained using independent appraisals, which the Company considers to be Level 2 inputs. The aggregate carrying amount of impaired loans at March 31, 2010 was \$37.4 million.

*Foreclosed Assets* Foreclosed assets are adjusted to fair value upon transfer of the loans to foreclosed assets. Foreclosed assets are carried at the lower of the carrying value or fair value. Fair value is based upon independent observable market prices or appraised values of the collateral, which the Company considers to be level 2 inputs. When the appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Company records the foreclosed asset as nonrecurring Level 3.

Assets and liabilities measured at fair value on a recurring basis are as follows as of March 31, 2010:

|                                   | Quoted market<br>price in<br>active<br>markets<br>(Level 1) | Significant other<br>observable<br>inputs<br>(Level 2) | Significant<br>unobservable<br>inputs<br>(Level 3) |
|-----------------------------------|---|--|--|
| <b>(Dollars are in thousands)</b> |   |  |  |
| <b>(On a recurring basis)</b>     |   |  |  |
| U. S. Government Agencies         | \$  | \$ 2,026   | \$   |
| Mortgage backed securities        |   | 718  |  |
| Taxable municipals                |   | 882  |  |
| <b>(On a nonrecurring basis)</b>  |   |  |  |
| Other real estate owned           |   | 1,968  | 6,008  |
| Impaired loans                    |   | 37,428   |  |

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|       |    |    |        |    |       |
|-------|----|----|--------|----|-------|
| Total | \$ | \$ | 43,022 | \$ | 6,008 |
|-------|----|----|--------|----|-------|

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**Table of Contents****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****NOTE 8 FAIR VALUE (CONTINUED):**

Assets and liabilities measured at fair value are as follows as of December 31, 2009:

| (Dollars are in thousands)     | Quoted market<br>price in<br>active<br>markets<br>(Level 1) | Significant other<br>observable<br>inputs<br>(Level 2) | Significant<br>unobservable<br>inputs<br>(Level 3) |
|--------------------------------|---|--|--|
| (On a recurring basis)         |   |  |  |
| Available for sale investments | \$  | \$ 2,606   | \$   |
| (On a non-recurring basis)     |   |  |  |
| Other real estate owned        |   | 1,968  | 3,675  |
| Impaired loans                 |   | 30,139   |  |
| Total                          | \$  | \$ 38,388  | \$ 3,675   |

Transfers into Level 3 during the quarter ended March 31, 2010 were related to management adjustments to third party appraisals. Management estimated the fair value of these loans to be further impaired and thereby below the appraised value, resulting in no observable market price. For the three months ended March 31, 2010, the changes in Level 3 assets measured at fair value on a recurring basis are summarized as follows (dollars in thousands):

|                                 | Three<br>Months Ended<br>March 31, 2010<br>Impaired Loans |
|---------------------------------|---|
| Balance, January 1, 2010        | \$ 3,675  |
| Included in earnings            |   |
| Transfers into (out of) Level 3 | 2,333   |
| Principal reductions            |   |
| Balance, March 31, 2010         | \$ 6,008  |

There were no transfers from Level 3 to Level 2. The Company has no liabilities carried at fair value or measured at fair value on a recurring or nonrecurring basis.

**Fair Value of Financial Instruments**

Fair value information about financial instruments, whether or not recognized in the balance sheet, for which it is practical to estimate the value is based upon the characteristics of the instruments and relevant market information. Financial instruments include cash, evidence of ownership in an entity, or contracts that convey or impose on an entity that contractual right or obligation to either receive or deliver cash for another financial instrument.

The following summary presents the methodologies and assumptions used to estimate the fair value of the Company's financial instruments presented below. The information used to determine fair value is highly subjective and judgmental in nature and, therefore, the results may not be precise. Subjective factors include, among other things, estimates of cash flows, risk characteristics, credit quality, and interest rates, all of which are subject to change. Since the fair value is estimated as of the balance sheet date, the amounts that will actually be realized or paid upon

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settlement or maturity on these various instruments could be significantly different.

The carrying value of cash and due from banks, federal funds sold, interest-bearing deposits, deposits with no stated maturities, trust preferred securities and accrued interest approximates fair value. The estimated fair value of investment securities was based on closing market prices. The remaining financial instruments were valued based on the present value of estimated future cash flows, discounted at various rates in effect for similar instruments during the months of March 2010 and December 2009.

**Table of Contents****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****NOTE 8 FAIR VALUE (CONTINUED):**

|                                   | March 31, 2010             |                   | December 31, 2009          |                   |
|-----------------------------------|----------------------------|-------------------|----------------------------|-------------------|
|                                   | Estimated<br>Fair<br>Value | Carrying<br>Value | Estimated<br>Fair<br>Value | Carrying<br>Value |
| <b>(Dollars are in thousands)</b> |                            |                   |                            |                   |
| <b>Financial Assets</b>           |                            |                   |                            |                   |
| Cash and due from bank            | \$ 33,729                  | \$ 33,729         | \$ 29,978                  | \$ 29,978         |
| Federal funds sold                | 16,586                     | 16,586            | 9,582                      | 9,582             |
| Investment securities             | 3,626                      | 3,626             | 2,606                      | 2,606             |
| Equity securities (restricted)    | 4,014                      | 4,014             | 3,996                      | 3,996             |
| Loans                             | 765,078                    | 758,364           | 770,087                    | 763,570           |
| Accrued interest receivable       | 4,541                      | 4,541             | 4,292                      | 4,292             |
| Life insurance investments        | 10,655                     | 10,655            | 10,549                     | 10,549            |
| <b>Financial Liabilities</b>      |                            |                   |                            |                   |
| Demand Deposits                   |                            |                   |                            |                   |
| Non-interest bearing              | 92,505                     | 92,505            | 88,318                     | 88,318            |
| Interest-bearing                  | 54,693                     | 54,693            | 42,769                     | 42,769            |
| Savings deposits                  | 88,567                     | 88,567            | 90,467                     | 90,467            |
| Time deposits                     | 536,940                    | 534,519           | 541,793                    | 539,160           |
| FHLB advances                     | 24,303                     | 25,083            | 24,612                     | 25,383            |
| Accrued interest payable          | 1,651                      | 1,651             | 1,617                      | 1,617             |
| Line of credit borrowing          | 4,900                      | 4,900             | 4,900                      | 4,900             |
| Trust preferred securities        | 16,496                     | 16,496            | 16,496                     | 16,496            |

**NOTE 9 RECENT ACCOUNTING DEVELOPMENTS:**

The following is a summary of recent authoritative announcements.

In January 2010, fair value guidance was amended to require disclosures for significant amounts transferred in and out of Levels 1 and 2 and the reasons for such transfers and to require that gross amounts of purchases, sales, issuances and settlements be provided in the Level 3 reconciliation. The new disclosures are effective for the Company for the current quarter and have been reflected in the Fair Value footnote.

Guidance related to subsequent events was amended in February 2010 to remove the requirement for an SEC filer to disclose the date through which subsequent events were evaluated. The amendments were effective upon issuance and had no significant impact on the Company's financial statements.

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

**NOTE 10 SUBSEQUENT EVENT:**

On April 29, 2010, the Bank partially charged off \$3.5 million on a \$6.9 million credit located in Pigeon Forge, TN. The impairment was already reserved and had no immediate impact on earnings.

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### **Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations Caution About Forward Looking Statements**

We make forward looking statements in this quarterly report that are subject to risks and uncertainties. These forward looking statements include statements regarding our profitability, liquidity, allowance for loan losses, interest rate sensitivity, market risk, business strategy, and financial and other goals. The words believes, expects, may, will, should, projects, contemplates, anticipates, forecasts, intends, or other terms are intended to identify forward looking statements.

Certain information contained in this discussion may include forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended and Section 21E of the Securities Exchange Act of 1934, as amended. These forward-looking statements contain the Company's expectations, plans, future financial performance, and other statements that are not historical facts. These forward-looking statements are generally identified by phrases such as the Company expects, the Company believes or words of similar import. Such forward-looking statements involve known and unknown risks including, but not limited to, changes in general economic and business conditions, interest rate fluctuations, competition within and from outside the banking industry, new products and services in the banking industry, risk inherent in making loans such as repayment risks and fluctuating collateral values, problems with technology utilized by the Company, changing trends in customer profiles and changes in laws and regulations applicable to the Company. Although the Company believes that its expectations with respect to the forward-looking statements are based upon reasonable assumptions within the bounds of its knowledge of its business and operations, there can be no assurance that actual results, performance or achievements of the Company will not differ materially from any future results, performance or achievements expressed or implied by such forward-looking statements.

Because of these uncertainties, our actual future results may be materially different from the results indicated by these forward looking statements. In addition, our past results of operations do not necessarily indicate our future results.

#### **Overview**

The Company had net income for the quarter ended March 31, 2010 of \$413 thousand as compared to net income of \$906 thousand for the period ended March 31, 2009. Basic net income per share was \$0.04 for the quarter ended March 31, 2010 as compared to basic net income of \$0.09 for the quarter ended March 31, 2009.

In the first quarter of 2010, we experienced an increase in our net interest margin to 4.22%, as compared to 3.99% for the same period in 2009. However, we reported a decrease in net income from \$906 thousand in 2009 to \$413 thousand in 2010 as a result of a \$1.6 million increase in provision for loan losses and significant increases in FDIC premiums for the quarter. The increase in the provision is due to an increase in individual impaired loans recognized in the first quarter of 2010 and their respective estimated loss exposure. Approximately \$3.5 million of the increase are loans made to an individual and related entities primarily for agricultural purposes with a \$1.0 million estimated exposure. In addition, \$2.1 million to another borrower and related entity in the automotive industry was considered impaired with an estimated \$337 thousand exposure. The third increase to the impaired loan total was to another borrower in a construction related business totaling \$1.7 million with an estimated \$475 thousand exposure. The allowance for loan loss has been increased to a level that management deems appropriate to absorb any potential future losses and known impairment within the loan portfolio whether or not the losses are actually ever realized. At March 31, 2010, the allowance for loan losses was \$19.3 million (2.55% of total loans) as compared to \$18.6 million (2.43% of total loans) at December 31, 2009.

At March 31 2010, the Company's total assets increased \$9.8 million, or 1.14%, to \$867.7 million from \$857.9 million at December 31, 2009. Total loans decreased to \$758.4 million at March 31, 2010 from \$763.6 million at year end 2009. We are intentionally reducing our higher risk loans; and as a result, total loans are decreasing. We foresee this continuing throughout 2010. Total deposits increased \$9.6 million from \$760.7 million at December 31, 2010 to \$770.3 million at March 31, 2010.

We are continuing to experience a deterioration in asset quality. However, we are identifying potential problems early in efforts to minimize losses. As we identify potential losses, we are making conservative, yet realistic, provisions to the allowance for loan losses. The ratio of nonperforming assets to total assets is 4.50% at March 31, 2010 in comparison to 3.99% at December 31, 2009. Nonperforming assets, which include nonaccrual loans, other real estate owned and past due loans greater than 90 days still accruing interest, were \$39.0 million at March 31, 2010 and \$34.2 million at December 31, 2009. The majority of these assets are real estate development projects. We are working aggressively to reduce these totals primarily by working with the customer for additional collateral, restructuring the debt, but we also may have to foreclose, repossess collateral and other prudent measures. However, it is uncertain how long this will take. In the first quarter, net charge offs were \$1.3 million as compared to \$201 thousand in the first quarter of 2009. The majority of the charge offs in 2010 is related to a foreclosure of a real estate development property in the Coastal Carolina region. Subsequent to the first quarter, we partially charged off \$3.5 million of a \$7.0 million real estate development property in Pigeon Forge, Tennessee. Foreclosure proceedings were delayed upon the borrower's bankruptcy filing in April 2010. Foreclosure plans will continue. Both of these charge-offs were identified as impaired loans with a proper reserve in the

allowance for loan losses at December 31, 2009.

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We have made several changes to improve asset quality. A newly revamped loan policy and procedures has been approved in the second quarter of 2010 with more conservative underwriting criteria. Lending personnel will be trained on the new policy and procedures which are to be fully implemented June 1, 2010. We have improved our detection and monitoring processes of problem loans. A Special Assets division headed by our former Chief Credit Officer has been established with primary focus upon delinquent loans greater than 60 days past due, other real estate owned, repossessed collateral and impaired credits. An action plan is required for each credit and reported monthly to the Watch List Committee. A determination is made if the loan will be in nonaccrual status or not, and if the loan is impaired and requiring a specific allowance for a deficiency. The risk grade is evaluated and changed accordingly. Each loan officer is responsible for delinquencies with assistance from the Special Assets division. The Board of Directors monitors the actions on impaired loans on a monthly basis. We have engaged a third party loan review company, Credit Risk Management, who performed a loan review in the first quarter and is scheduled for additional reviews each quarter in 2010. We are improving our loan portfolio concentrations management relative to industries, borrowers, and types of credits. Each of these steps along with management changes will improve asset quality issues, particularly related to new loans and the resolution of problem loans.

We are currently evaluating and planning for the Company's needs and opportunities. As part of this planning initiative, we are in the process of developing our strategic plan for the next three years. We are also determining the needs of the organization regarding management, board members and succession planning. With recent changes in management and transition from a high growth company to a maturing organization, we have hired a consultant to independently assess our Board of Directors and Senior Management team. We have recently conducted a loan portfolio stress test to determine capital levels needed and potential losses over the next three years. In evaluating potential capital needs for anticipated growth and potential inherent loan loss risks, it is possible, that a stock offering may be completed to meet the capital needs of the Company.

The Bank remains well capitalized for regulatory purposes. The following ratios existed at March 31, 2010: Tier 1 leverage ratio of 7.10%, Tier 1 risk based capital ratio of 9.42%, and Total risk based capital ratio of 10.69%. The ratios were as follows at December 31, 2009: Tier 1 leverage ratio of 7.07%, Tier 1 risk based capital ratio of 9.32%, and Total risk based capital ratio of 10.59%. The increase in the ratios was caused by the retained earnings and slower asset growth during the first quarter of 2010. We anticipate limited asset growth in the future and capital growth through retained earnings during the remainder of 2010.

## **Critical Accounting Policies**

Certain critical accounting policies affect the more significant judgments and estimates used in the preparation of our financial statements. The most critical accounting policy relates to our provision for loan losses, which reflects the estimated losses resulting from the inability of our customers to make required payments. If the financial condition of our borrowers were to further deteriorate, resulting in an impairment of their ability to make payments, our estimates would be updated, and additional provisions could be required. For further discussion of the estimates used in determining the allowance for loan losses, we refer you to the section on Provision for Loan Losses below. For discussion of our significant accounting policies see our Annual Report on Form 10-K for the year ended December 31, 2009.

## **Balance Sheet Changes**

At March 31, 2010, total assets were \$867.7 million, an increase of \$9.8 million, or 1.14%, over December 31, 2009. Total deposits grew \$9.6 million, or 1.26%, for the first three months of 2010 to \$770.3 million from \$760.7 million at December 31, 2009. Total loans decreased \$5.2 million, or 0.68%, to \$758.4 million at March 31, 2010 from \$763.6 million at December 31, 2009.

We continue to experience an increase in core deposits as interest bearing and noninterest bearing demand deposits grew. Interest bearing demand deposits increased 27.88%, or \$11.9 million, from \$42.8 million at December 31, 2009 to \$54.7 million at March 31, 2010. We have been focusing on increasing core deposits and are seeing success in our efforts.

We have experienced a slight decrease in time deposits and savings deposits primarily as a result of lowered deposit rates. We are strategically shifting our source of funds for loan growth from higher cost noncore deposits. It is possible that we will continue to see a slight decrease in each of these categories through 2010.

Total loans decreased \$5.2 million, or 0.68%, to \$758.4 million at March 31, 2010 from \$763.6 million at December 31, 2009. The decrease is partially due to a \$3.4 million loan placed in other real estate owned and a portion of it charged off against the allowance for loan loss. In addition, although we continue to serve the credit needs of our area, we are also conservatively underwriting each credit to prevent future losses if the economy would decline further. As a result, we are experiencing some loan volume decrease and expect this to continue especially as we work out problem credits.





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As a result of the decrease in the loan portfolio and an increase in deposits, our asset based liquidity is showing improvement.

### **Net Interest Income, Net Interest Margin, and Interest Sensitivity**

Net interest income increased \$963 thousand, or 13.04%, to \$8.3 million for the first quarter of 2010 from \$7.4 million for the same period in 2009. We have continued to lower our cost of funds in 2010 due to both an increase in core demand deposits and decreased interest rates on time deposits. We have experienced an increase in net interest income as a result. Our net interest margin increased to 4.22% in the first quarter of 2010 as compared to 3.99% for the same period in 2009. If interest rates remain low, our cost of funds should continue to decrease. The increase of nonaccrual loans, however, negatively affects the net interest margin as these loans are nonearning assets. If non-accruing loans increase, it may reduce our net interest margin. At March 31, 2010, we had an improvement in our negative cumulative gap rate sensitivity ratio of 46.90% for the one year re-pricing period compared to the negative cumulative gap of 50.00% at December 31, 2009. We are strategically shifting our repricing gap position to take advantage of rising interest rates whenever this begins to occur. The negative cumulative gap generally indicates that earnings would improve in a declining interest rate environment as liabilities (deposits) re-price more quickly than assets (loans). Conversely, earnings would probably decrease in periods when interest rates are increasing. We believe as our liabilities continue to reprice more quickly than our assets in the near future, our cost of funds will decrease more quickly than our yield on earning assets. With the positive shift in our gap position, we are moving in the right direction to improve net interest income in an increasing interest rate environment.

### **Noninterest Income**

Noninterest income increased \$200 thousand, or 17.01%, to \$1.4 million in the first quarter of 2010 from \$1.2 million in 2009. The increase is the result of increased deposit volume and increased ATM and debit card interchange fees. Noninterest income as a percentage of average assets (annualized) was 0.63% and 0.58% for the quarter ended March 31, 2010 and 2009, respectively.

### **Noninterest Expense**

Noninterest expense totaled \$7.1 million for the first quarter of 2010 as compared to \$6.8 million for the first quarter of 2009. The primary contributor to the increase in noninterest expenses for the quarter is the increase in FDIC premiums. During the first quarter of 2010, the FDIC accrued insurance premium totaled \$750 thousand as compared to \$197 thousand for the same period in 2009. The FDIC expense is attributed to the FDIC's Temporary Liquidity Guarantee Program (TLGP), increased volume in deposit balances, and increased FDIC rates charged on deposits.

Salaries and benefits decreased in the quarter-to-quarter comparison. In the first quarter of 2010, \$400 thousand was reversed from expense as the accrued salary continuation agreement with the former President and CEO was terminated. Otherwise, salaries and benefits would have been approximately the same.

Our efficiency ratio, which is defined as noninterest expense less intangible expenses divided by the sum of net interest income plus noninterest income, improved to 73.07% for the first quarter of 2010 as compared to 79.49% for the same period in 2009. As we halt future branch expansion, we anticipate noninterest expenses to remain steady with potential improvement as FDIC premiums go down at some time in the future.

Noninterest expense as a percentage of average assets at March 31, 2010 was 3.29% as compared to 3.35% for the first quarter of 2009.

### **Provision for Loan Losses**

The calculation of the allowance for loan losses is considered a critical accounting policy. The adequacy of the allowance for loan losses is based upon management's judgment and analysis. The following factors are evaluated in determining the adequacy of the allowance: risk characteristics of the loan portfolio, current and historical loss experience, loan concentrations and internal and external factors such as general economic conditions.

Certain risks exist in the Bank's loan portfolio. Since the Bank began in 1998, we have experienced significant loan growth each year. Although we employ experienced lenders who are familiar with their customer base, some of the loans are too new to have exhibited signs of weakness. Recent expansions into new markets increased potential credit risk. In addition, a majority of the loans are collateralized by real estate. It is our policy to sufficiently collateralize loans to minimize loss exposures in case of default. The recent negative trends in the national real estate market and economy have impacted the quality of our loan portfolio, particularly certain participation loans secured by real estate in Coastal Carolina and Tennessee. Local real estate market values have remained stable, while national real estate markets have experienced a downturn. However, real estate sales activity has slowed somewhat in our market. Recent real estate appraisals and appraisers have indicated our real estate

market has remained stable in terms of values.

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Construction and development loans have been impacted the most as new housing sales have declined. The most adversely affected area of our loan portfolio is outside of our local market area. Most of these loans are located in the Coastal Carolina area and were obtained by purchasing participations. During the first quarter of 2010, we foreclosed on a \$3.4 million loan in the Coastal Carolina area and charged off \$1.1 million. The total of these credits at March 31, 2010 was \$9.1 million as compared to \$12.7 million at December 31, 2009 of which \$2.8 million were impaired at March 31, 2010 with no estimated exposure amount. This market area has posed some higher risk, but decreased collateral values still provide adequate coverage on the remaining Coastal Carolina credits. Total loans originated in the northeastern Tennessee market were \$61.1 million at March 31, 2010 and \$61.8 million at December 31, 2009. Of these loans, \$15.5 million were impaired at March 31, 2010 with an estimated exposure of \$6.2 million. A loan totaling approximately \$7.0 million in northeastern Tennessee included in the \$15.5 million mentioned above has been partially charged off by \$3.5 million subsequent to the end of the first quarter 2010.

Our market area is somewhat diverse, but certain areas are more reliant upon agriculture and coal mining. As a result, increased risk of loan impairments is possible if these industries experience a significant downturn. Legislation that results in stricter clean air regulations could have an adverse effect upon certain segments of our market. While we do not foresee stricter clean air legislation happening in the near future, the economic recession has warranted a more conservative assessment of the potential risks that our agricultural and coal related credits present. Unemployment levels remain high, nearly 10% within our market, and we have experienced an increase in delinquencies. We have reviewed and will continue to review the loan portfolio for potential future problem loans. As a result, we have downgraded several loan relationships in light of the economic recession and increased delinquencies. Loans that appear to reflect higher levels of risk, such as past due loans, larger loans in weakened industries, concentrations, etc., are individually reviewed for impairment. An evaluation is made to determine if the collateral is sufficient for each of these credits. If an exposure exists, a specific allowance is made for the amount of the potential loss. The evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available. Impaired loans increased to \$37.4 million with a valuation allowance of \$10.7 million as compared to \$30.1 million with a valuation allowance of \$8.8 million at December 31, 2009. We consider our significant loan growth, construction and development loans, out of market loans, potential adverse legislation, and an increase in unemployment and delinquencies to be the primary higher risk characteristics of the loan portfolio, and accordingly, we have made an aggressive provision to the allowance for loan loss.

Of the \$37.4 million, or 4.94% of total loans, recorded as impaired loans at March 31, 2010, \$31.0 million were nonperforming loans, which included 100 non-accrual loans totaling \$25.4 million as compared to 80 non-accrual loans totaling \$24.74 million at December 31, 2009. Loans past due 90 days or more totaled \$5.6 million at March 31, 2010 as compared to \$3.9 million at December 31, 2009. At March 31, 2010, these nonperforming loans as a percentage of total loans were 4.09% as compared to \$28.6 million, or 3.74% of total loans, at December 31, 2009. It is our policy to stop accruing interest on a loan, and to classify that loan as non-accrual, under the following circumstances: (a) whenever we are advised by the borrower that scheduled principal or interest payments cannot be met, (b) when our best judgment indicates that payment in full of principal and interest can no longer be expected, or (c) when any such loan or obligation becomes delinquent for 90 days unless it is both well secured and in the process of collection. We have identified \$7.3 million as troubled debt restructurings as defined by Generally Accepted Accounting Principles, Troubled Debt Restructurings by Creditors. There are no loans identified as potential problem loans. We do not have any commitments to lend additional funds to non-performing debtors.

**Liquidity**

At March 31, 2010 and December 31, 2009, we had liquid assets in the form of cash, due from banks and federal funds sold of approximately \$50.3 million and \$39.6 million, respectively. At March 31, 2010, all of our investments are classified as available-for-sale, providing an additional source of liquidity in the amount of \$2.7 million, which is net of those securities pledged as collateral for public funds. We are currently developing an investment portfolio from excess liquid funds and to provide future liquidity needs. The investment portfolio will be kept fairly short in duration.

Our loan to deposit ratio was 98.45% at March 31, 2010 and 100.38% at year end 2009. We anticipate this ratio to decrease as we continue to grow deposits in our branch network and decrease our loan portfolio throughout 2010.

We do not foresee having to utilize our lines of credit for liquidity needs in the near future. In the event we need additional funds, we have federal funds available for overnight borrowing under established lines of credit totaling \$27.4 million. We have recently been requested by one of our correspondent banks, Compass Bank, to secure our \$5.0 million federal funds line of credit. We expect to do this in the second quarter of 2010 by purchasing a short term certificate of deposit with Compass Bank. We also have a line of credit through the Federal Home Loan Bank of Atlanta collateralized with 1 to 4 residential real estate loans. This line has \$69.7 million in available funds at March 31, 2010. In addition, we are members of the CDARs network which allows us to bid on deposits and obtain additional funds. The Bank obtained approval to borrow funds from the Federal Reserve Bank discount window during the quarter ended September 30, 2009. We may collateralize this line with investment securities and loans at our discretion. We currently do not have collateral pledged, but we may physically deliver collateral to the Federal Reserve and obtain funding. We do not, however, anticipate using this funding source.



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Management continues to pursue refinancing of the Silverton Bridge Bank line of credit referred to in Note 7 above and also addressed in more detail in our Form 10-K for the periods ended December 31, 2009. Currently that line is in technical default due to noncompliance with debt covenants. Payment in full could be required, and although we have been asked to refinance this loan, the holder has not demanded payment at this time. We are paying interest payments quarterly and are not delinquent in our payments. If the note was called for the technical default, there may not be sufficient funds at the parent company to repay the debt. This event would severely impact our liquidity. The collateral that secures the \$4.9 million line of credit is the common stock of the Bank. If the note were called and sufficient funds could not be obtained, the lender could exercise its rights as a secured creditor with respect to the Bank stock. In the current banking environment, it is very difficult to obtain holding company lines of credit, but management is pursuing this. An equity offering may be required to repay this line of credit.

Recently the FDIC extended its Temporary Liquidity Guarantee Program through December 31, 2010. We have chosen to not opt out of the program; therefore, all noninterest bearing deposit accounts and IOLTA deposit accounts will continue to be insured by the FDIC for an unlimited amount.

Our main source of liquidity is expected to be provided by the future growth that management expects in core deposit accounts and from loan repayments. We believe that this future growth will result from an increase in market share in our targeted trade areas and decreased loan volume. With the lines of credit available and the anticipated deposit growth, we believe we have adequate liquidity to meet our requirements and needs for the foreseeable future.

## **Capital Resources**

Total capital at the end of the first quarter of 2010 was \$47.0 million as compared to \$46.6 million at the end of December 31, 2009. Regulatory capital ratios remain in excess of defined regulatory requirements for a well capitalized institution. However, as stated earlier, we are exploring options to increase capital which may include a stock offering.

No cash dividends have been paid historically and none are anticipated in the foreseeable future. The Company's strategic plan is to grow at a much slower pace than in the earlier years of operation. To accommodate this growth and have sufficient capital, earnings will need to be retained.

## **Off Balance Sheet Items**

There have been no material changes during the quarter ended March 31, 2010 to the off-balance sheet items disclosed in our annual report on Form 10-K for the fiscal year ended December 31, 2009.

## **Contractual Obligations**

There were no material changes during the quarter ended March 31, 2010 to the contractual obligations disclosed in our annual report on Form 10-K for the fiscal year ended December 31, 2009.

## **Item 3. Quantitative and Qualitative Disclosures About Market Risk**

There have been no material changes in market risks faced by the Company during the quarter ended March 31, 2010. For information regarding the Company's market risk, refer to the Company's Annual Report on Form 10-K for the year ended December 31, 2009.

## **Item 4. Controls and Procedures**

We have carried out an evaluation, under the supervision and with the participation of our management, including our President and Chief Executive Officer (our CEO) and our Executive Vice President and Chief Financial Officer (our CFO), of the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)) as of the end of the period covered by this report. Based upon that evaluation, our CEO and CFO concluded that our disclosure controls and procedures were operating effectively in providing reasonable assurance that (a) the information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms, and (b) such information is accumulated and communicated to our management, including our CEO and CFO, as appropriate to allow timely decisions regarding required disclosure.

**Part II Other Information**

**Item 1. Legal Proceedings**

In the course of our operations, we may become a party to legal proceedings. We became aware of a lawsuit against the Bank in April 2010. This case involves a claim against the Bank by a joint venture between bank customers, some of

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whom are former members of senior management, and three investors. The allegation is that the joint venture, VFI, should have priority over the Bank's deed of trust in order for VFI's unrecorded and unrecordable ground lease to be enforceable for its full ten year term. We believe VFI's position is not supported by law or the facts presented.

**Item 1A. Risk Factors**

There have been no material changes in the risk factors faced by the Company from those disclosed in the Company's Form 10-K for the year ended December 31, 2009.

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

Not Applicable

**Item 3. Defaults Upon Senior Securities**

Not Applicable

**Item 4. (Removed and Reserved).**

**Item 5. Other Information**

Not Applicable

**Item 6. Exhibits**

The following exhibits are filed as part of this Form 10-Q, and this list includes the exhibit index:

| No.  | Description   |
|------|---|
| 31.1 | Certification by Chief Executive Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 2004.                         |
| 31.2 | Certification by Chief Financial Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 2004.                         |
| 32   | Certification by Chief Executive Officer and Chief Financial Officer, as required by Section 906 of the Sarbanes-Oxley Act of 2002. |



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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.

**NEW PEOPLES BANKSHARES, INC.  
(Registrant)**

By: /s/ JONATHAN H. MULLINS  
Jonathan H. Mullins  
President and Chief Executive Officer  
Date: May 10, 2010

By: /s/ C. TODD ASBURY  
C. Todd Asbury  
Executive Vice President and Chief Financial  
Officer  
Date: May 10, 2010