

CAPITAL ONE FINANCIAL CORP
 Form 4
 February 11, 2008

FORM 4

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

OMB APPROVAL

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STATEMENT OF CHANGES IN BENEFICIAL OWNERSHIP OF SECURITIES

Filed pursuant to Section 16(a) of the Securities Exchange Act of 1934, Section 17(a) of the Public Utility Holding Company Act of 1935 or Section 30(h) of the Investment Company Act of 1940

(Print or Type Responses)

1. Name and Address of Reporting Person *
FAIRBANK RICHARD D

2. Issuer Name and Ticker or Trading Symbol
CAPITAL ONE FINANCIAL CORP [COF]

5. Relationship of Reporting Person(s) to Issuer
 (Check all applicable)

(Last) (First) (Middle)
1680 CAPITAL ONE DRIVE
 (Street)

3. Date of Earliest Transaction (Month/Day/Year)
02/07/2008

Director 10% Owner
 Officer (give title below) Other (specify below)
Chairman, CEO and President

MCLEAN, VA 22102
 (City) (State) (Zip)

4. If Amendment, Date Original Filed(Month/Day/Year)

6. Individual or Joint/Group Filing(Check Applicable Line)
 Form filed by One Reporting Person
 Form filed by More than One Reporting Person

Table I - Non-Derivative Securities Acquired, Disposed of, or Beneficially Owned

1. Title of Security (Instr. 3)	2. Transaction Date (Month/Day/Year)	2A. Deemed Execution Date, if any (Month/Day/Year)	3. Transaction Code (Instr. 8)	4. Securities Acquired (A) or Disposed of (D) (Instr. 3, 4 and 5)	5. Amount of Securities Beneficially Owned Following Reported Transaction(s) (Instr. 3 and 4)	6. Ownership Form: Direct (D) or Indirect (I) (Instr. 4)	7. Nature of Ownership (Instr. 4)
				(A) or (D)	Price		
Common Stock <u>(1)</u> <u>(2)</u>	02/07/2008		S	200	D \$ 49.45	2,457,762	D
Common Stock <u>(1)</u>	02/07/2008		S	200	D \$ 49.46	2,457,562	D
Common Stock <u>(1)</u>	02/07/2008		S	200	D \$ 49.47	2,457,362	D
Common Stock <u>(1)</u>	02/07/2008		S	100	D \$ 49.48	2,457,262	D
Common Stock <u>(1)</u>	02/07/2008		S	100	D \$ 49.5	2,457,162	D

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Common Stock <u>(1)</u>	02/07/2008	S	100	D	\$ 49.51	2,457,062	D
Common Stock <u>(1)</u>	02/07/2008	S	300	D	\$ 49.52	2,456,762	D
Common Stock <u>(1)</u>	02/07/2008	S	100	D	\$ 49.53	2,456,662	D
Common Stock <u>(1)</u>	02/07/2008	S	100	D	\$ 49.54	2,456,562	D
Common Stock <u>(1)</u>	02/07/2008	S	100	D	\$ 49.55	2,456,462	D
Common Stock <u>(1)</u>	02/07/2008	S	400	D	\$ 49.56	2,456,062	D
Common Stock <u>(1)</u>	02/07/2008	S	100	D	\$ 49.58	2,455,962	D
Common Stock <u>(1)</u>	02/07/2008	S	100	D	\$ 49.6	2,455,862	D
Common Stock <u>(1)</u>	02/07/2008	S	200	D	\$ 49.63	2,455,662	D
Common Stock <u>(1)</u>	02/07/2008	S	100	D	\$ 49.64	2,455,562	D
Common Stock <u>(1)</u>	02/07/2008	S	100	D	\$ 49.65	2,455,462	D
Common Stock <u>(1)</u>	02/07/2008	S	100	D	\$ 49.66	2,455,362	D
Common Stock <u>(1)</u>	02/07/2008	S	100	D	\$ 49.68	2,455,262	D
Common Stock <u>(1)</u>	02/07/2008	S	200	D	\$ 49.71	2,455,062	D
Common Stock <u>(1)</u>	02/07/2008	S	100	D	\$ 49.72	2,454,962	D
Common Stock <u>(1)</u>	02/07/2008	S	300	D	\$ 49.73	2,454,662	D
Common Stock <u>(1)</u>	02/07/2008	S	100	D	\$ 49.74	2,454,562	D
Common Stock <u>(1)</u>	02/07/2008	S	100	D	\$ 49.76	2,454,462	D
Common Stock <u>(1)</u>	02/07/2008	S	100	D	\$ 49.77	2,454,362	D
Common Stock <u>(1)</u>	02/07/2008	S	200	D	\$ 49.79	2,454,162	D
	02/07/2008	S	100	D	\$ 49.8	2,454,062	D

Common
Stock ⁽¹⁾

Common
Stock

107,502 I

By
Fairbank
Morris

Reminder: Report on a separate line for each class of securities beneficially owned directly or indirectly.

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SEC 1474
(9-02)

Table II - Derivative Securities Acquired, Disposed of, or Beneficially Owned
(e.g., puts, calls, warrants, options, convertible securities)

1. Title of Derivative Security (Instr. 3)	2. Conversion or Exercise Price of Derivative Security	3. Transaction Date (Month/Day/Year)	3A. Deemed Execution Date, if any (Month/Day/Year)	4. Transaction Code (Instr. 8)	5. Number of Derivative Securities Acquired (A) or Disposed of (D) (Instr. 3, 4, and 5)	6. Date Exercisable and Expiration Date (Month/Day/Year)	7. Title and Amount of Underlying Securities (Instr. 3 and 4)	8. Price of Derivative Security (Instr. 5)	9. Number of Derivative Securities Beneficially Owned Following Reported Transaction (Instr. 6)
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Reporting Owners

Reporting Owner Name / Address	Relationships			
	Director	10% Owner	Officer	Other
FAIRBANK RICHARD D 1680 CAPITAL ONE DRIVE MCLEAN, VA 22102	X		Chairman, CEO and President	

Signatures

/s/ Tangela S. Richter (POA) on file for Richard D.
Fairbank

02/11/2008

**Signature of Reporting Person

Date

Explanation of Responses:

* If the form is filed by more than one reporting person, see Instruction 4(b)(v).

** Intentional misstatements or omissions of facts constitute Federal Criminal Violations. See 18 U.S.C. 1001 and 15 U.S.C. 78ff(a).

(1) This transaction was executed pursuant to a trading plan entered into by the Reporting Person on February 1, 2007, in accordance with Rule 10b5-1 under the Securities Exchange Act of 1934, as amended.

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- (2) Due to SEC rules limiting the number of non-derivative transactions that can be reported on a single Form 4, this Form 4 is a continuation of the Form 4 filed for the same date listed above.

Note: File three copies of this Form, one of which must be manually signed. If space is insufficient, see Instruction 6 for procedure.

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Total

\$943,036 \$1,668,126 \$10,257,293 \$12,868,455 \$402,932,696 \$415,801,151 \$288,618

* Includes \$9,968,675 of non-accrual loans.

Impaired loans

A loan is considered impaired when, based on current information and events; it is probable that the Company will be unable to collect the scheduled payments in accordance with the contractual terms of the loan. Factors considered in determining impairment include payment status, collateral value and the probability of collecting payments when due. The significance of payment delays and/or shortfalls is determined on a case by case basis. All circumstances surrounding the loan are taken into account. Such factors include the length of the delinquency, the underlying reasons and the borrower's prior payment record. Impairment is measured on these loans on a loan-by-loan basis. Impaired loans include non-accrual loans and other loans deemed to be impaired based on the aforementioned factors. At June 30, 2011, impaired loans consisted of other impaired loans totaling \$2,068,000, in addition to the \$9,591,000 of non-accrual loans. Other than the non-accrual loans, there were no other impaired loans as of December 31, 2010. Payments received on non-accrual loans are recognized on a cash basis. Payments are first applied against the outstanding principal balance, then to the recovery of any charged-off amounts. Any excess is treated as a recovery of interest income.

Impaired loans, segregated by class, are detailed below, as of the period indicated:

	Unpaid principal balance	Recorded investment with allowance	Recorded investment with no allowance	Total recorded investment	Related allowance
June 30, 2011					
Commercial & industrial	\$1,075,276	\$284,335	\$274,979	\$559,314	\$59,606
Commercial real estate:					
Non-owner occupied	2,031,415	299,475	1,476,725	1,776,200	210,726
Owner occupied	4,584,744	2,475,217	1,964,526	4,439,743	473,576
Construction	565,502	565,502	-	565,502	140,302
Consumer:					
Home equity installment	811,128	482,651	273,115	755,766	110,667
Home equity line of credit	358,395	39,741	318,654	358,395	6,670
Other	45,101	45,101	-	45,101	22,550
Residential:					
Real estate	3,085,160	1,835,768	1,228,263	3,064,031	354,484
Construction	94,389	94,389	-	94,389	15,615
Total	\$12,651,110	\$6,122,179	\$5,536,262	\$11,658,441	\$1,394,196

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	Unpaid principal balance	Recorded investment with allowance	Recorded investment with no allowance	Total recorded investment	Related allowance
December 31, 2010					
Commercial & industrial	\$811,545	\$-	\$164,583	\$164,583	\$-
Commercial real estate:					
Non-owner occupied	2,698,937	24,325	1,976,008	2,000,333	5,670
Owner occupied	2,768,036	2,444,999	323,037	2,768,036	522,835
Consumer:					
Home equity installment	718,656	286,188	314,557	600,745	29,495
Home equity line of credit	507,660	167,891	339,769	507,660	86,963
Auto	14,000	-	14,000	14,000	-
Other	13,467	-	13,467	13,467	-
Residential:					
Real estate	3,805,462	2,442,732	1,362,730	3,805,462	351,643
Construction	94,389	94,389	-	94,389	11,121
Total	\$11,432,152	\$5,460,524	\$4,508,151	\$9,968,675	\$1,007,727

Average investment in impaired loans, interest income recognized and cash basis interest income recognized from impaired loans, as of the period indicated, is as follows:

Six months ended June 30, 2011

	Average recorded investment	Interest income recognized	Cash basis interest income recognized
Commercial & industrial	\$ 296,160	\$ -	\$ -
Commercial real estate:			
Non-owner occupied	1,915,622	-	-
Owner occupied	3,918,845	26,309	13,987
Construction	188,501	-	-
Consumer:			
Home equity installment	687,277	5,727	2,917
Home equity line of credit	451,904	1,729	731
Auto	4,667	-	-
Other	19,523	33	33
Residential:			
Real estate	3,381,311	132,166	36,358
Construction	94,389	-	-
Total	\$ 10,958,199	\$ 165,964	\$ 54,026

Credit Quality Indicators

Commercial and industrial and commercial real estate

Explanation of Responses:

The Company utilizes a loan grading system and assigns a credit risk grade to its loans in the commercial and industrial and commercial real estate portfolios. The grading system provides a means to measure portfolio quality and aids in the monitoring of the credit quality of the overall loan portfolio. The credit risk grades are arrived at using a risk rating matrix to assign a grade to each of the loans in the commercial and industrial and commercial real estate portfolios.

The following is a description of each risk rating category the Company uses to classify each of its commercial and industrial and commercial real estate loans:

Pass

Loans in this category have an acceptable level of risk and are graded in range of one to five. Secured loans generally have good collateral coverage. Current financial statements reflect acceptable balance sheet ratios, sales and earnings trends. Management is considered to be good, and there is some depth existing. Payment experience on the loans has been good with minor or no delinquency experience. Loans with a grade of one are of the highest quality in the range. Those graded five are of marginally acceptable quality.

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Special Mention

Loans in this category are graded a six and may be protected but are potentially weak. They constitute a credit risk to the Company, but have not yet reached the point of adverse classification. Some of the following conditions may exist: little or no collateral coverage; lack of current financial information; delinquency problems; highly leveraged; available financial information reflects poor balance sheet ratios and profit and loss statements reflect uncertain trends; and document exceptions. Loans in this category should not remain on the list for an inordinate period of time (no more than one year) and then the loan should be passed or classified appropriately. Cash flow may not be sufficient to support total debt service requirements.

Substandard

Loans in this category are graded a seven and have a well defined weakness which may jeopardize the ultimate collectability of the debt. The collateral pledged may be lacking in quality or quantity. Financial statements may indicate insufficient cash flow to service the debt; and/or do not reflect a sound net worth. The payment history indicates chronic delinquency problems. Management is considered to be weak. There is a distinct possibility that the Company may sustain a loss. All loans on non-accrual are rated substandard. Loans 90+ days past due unless otherwise fully supported should be classified substandard. Also, borrowers that are bankrupt are substandard.

Doubtful

Loans in this category are graded an eight and have a better than 50% possibility of the Company sustaining a loss, but the loss cannot be determined because of specific reasonable factors which may strengthen credit in the near-term. Many of the weaknesses present in a substandard loan exist. Liquidation of collateral, if any, is likely. Any loan graded lower than an eight is considered to be uncollectible and charged-off.

Consumer and Residential

For these portfolios, the Company utilizes payment activity, history and recency of payment. Therefore, the consumer and residential loan segments are regarded as homogeneous loan pools and as such are not risk rated. Non-performing loans are considered to be loans past due 90 days or more and accruing and non-accrual loans. All loans not classified as non-performing are considered performing.

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The following table presents loans, segregated by class, categorized into the appropriate credit quality indicator category as of June 30, 2011 and December 31, 2010:

Commercial credit exposure

Credit risk profile by creditworthiness category

	Commercial and industrial		Commercial real estate - non-owner occupied		Commercial real estate - owner occupied		Commercial real estate - construction	
	6/30/2011	12/31/2010	6/30/2011	12/31/2010	6/30/2011	12/31/2010	6/30/2011	12/31/2010
Pass	\$79,271,331	\$82,041,657	\$73,768,500	\$81,139,543	\$60,677,580	\$61,219,553	\$12,346,424	\$9,438,500
Special mention	2,177,620	2,212,483	3,091,000	1,973,618	-	514,313	424,982	1,849,000
Substandard	1,996,519	875,134	4,121,491	4,242,164	8,315,993	7,604,074	565,502	1,213,000
Doubtful	-	-	-	-	-	-	-	-
Total	\$83,445,470	\$85,129,274	\$80,980,991	\$87,355,325	\$68,993,573	\$69,337,940	\$13,336,908	\$12,500,500

Consumer credit exposure

Credit risk profile based on payment activity

	Home equity installment		Home equity line of credit		Auto		Other	
	6/30/2011	12/31/2010	6/30/2011	12/31/2010	6/30/2011	12/31/2010	6/30/2011	12/31/2010
Performing	\$37,278,646	\$39,377,086	\$30,161,703	\$28,677,439	\$11,413,997	\$10,718,750	\$6,186,592	\$7,151,000
Non-performing	755,766	711,915	358,396	507,660	17,924	15,617	47,635	13,460
Total	\$38,034,412	\$40,089,001	\$30,520,099	\$29,185,099	\$11,431,921	\$10,734,367	\$6,234,227	\$7,164,460

Mortgage lending credit exposure

Credit risk profile based on payment activity

	Residential real estate		Residential construction	
	6/30/2011	12/31/2010	6/30/2011	12/31/2010
Performing	\$66,892,490	\$64,291,494	\$2,754,522	\$6,050,080
Non-performing	3,380,740	3,868,020	325,970	94,389
Total	\$70,273,230	\$68,159,514	\$3,080,492	\$6,144,469

Allowance for loan losses

Management continually evaluates the credit quality of the Company's loan portfolio and performs a formal review of the adequacy of the allowance for loan losses (the allowance) on a quarterly basis. The allowance reflects management's best estimate of the amount of credit losses in the loan portfolio. Management's judgment is based on

the evaluation of individual loans, past experience, the assessment of current economic conditions and other relevant factors including the amounts and timing of cash flows expected to be received on impaired loans. Those estimates may be susceptible to significant change. Loan losses are charged directly against the allowance when loans are deemed to be uncollectible. Recoveries from previously charged-off loans are added to the allowance when received.

Management applies two primary components during the loan review process to determine proper allowance levels. The two components are a specific loan loss allocation for loans that are deemed impaired and a general loan loss allocation for those loans not specifically allocated. The methodology to analyze the adequacy of the allowance for loan losses is as follows:

- § identification of specific impaired loans by loan category;
- § specific loans that are not impaired, but have an identified potential for loss;
- § calculation of specific allowances where required for the impaired loans based on collateral and other objective and quantifiable evidence;
- § determination of homogenous pools by loan category and eliminating the impaired loans;
- § application of historical loss percentages (two-year average) to pools to determine the allowance allocation;
- § application of qualitative factor adjustment percentages to historical losses for trends or changes in the loan portfolio. Qualitative factor adjustments include:
 - o levels of and trends in delinquencies and non-accrual loans;

- o levels of and trends in charge-offs and recoveries;
- o trends in volume and terms of loans;
- o changes in risk selection and underwriting standards;
- o changes in lending policies, procedures and practices;
- o experience, ability and depth of lending management;
- o national and local economic trends and conditions; and
- o changes in credit concentrations.

Allocation of the allowance for different categories of loans is based on the methodology as explained above. A key element of the methodology to determine the allowance is the Company's credit risk evaluation process, which includes credit risk grading of individual commercial and industrial and commercial real estate loans. Commercial and industrial and commercial real estate loans are assigned credit risk grades based on the Company's assessment of conditions that affect the borrower's ability to meet its contractual obligations under the loan agreement. That process includes reviewing borrowers' current financial information, historical payment experience, credit documentation, public information and other information specific to each individual borrower. Upon review, the commercial loan credit risk grade is revised or reaffirmed as the case may be. The credit risk grades may be changed at any time management feels an upgrade or downgrade may be warranted. The credit risk grades for the commercial and industrial and commercial real estate loan portfolios are taken into account in the reserve methodology and loss factors are applied based upon the credit risk grades. The loss factors applied are based upon the Company's historical experience as well as what we believe to be best practices and common industry standards. Historical experience reveals there is a direct correlation between the credit risk grades and loan charge-offs. The changes in allocations in the commercial and industrial and commercial real estate loan portfolio from period to period are based upon the credit risk grading system and from periodic reviews of the loan portfolio.

Each quarter, management performs an assessment of the allowance for loan losses. The Company's Special Assets Committee meets quarterly and the applicable lenders discuss each relationship under review and reach a consensus on the appropriate estimated loss amount based on current accounting guidance. The Special Assets Committee's focus is on ensuring the pertinent facts are considered and the reserve amounts pursuant to the accounting principles are reasonable. The assessment process includes the review of all loans on a non-accruing basis as well as a review of certain loans to which the lenders or the Company's Credit Administration function have assigned a criticized or classified risk rating.

The Company's policy is to charge off unsecured consumer loans when they become 90 days or more past due as to principal and interest. In the other portfolio segments, amounts are charged off at the point in time when the Company deems the balance to be uncollectible.

Information related to the change in the allowance for loan losses and the Company's recorded investment in loans by portfolio segment as of and for the periods indicated is as follows:

As of and for the six months ended June 30, 2011:	Commercial & industrial	Commercial real estate	Consumer	Residential real estate	Unallocated	Total
Allowance for loan losses:						
Beginning balance	\$ 1,367,531	\$ 4,238,272	\$ 1,249,306	\$ 862,654	\$ 180,059	\$ 7,897,822
Charge-offs	-	193,319	369,933	98,835	-	662,087

Explanation of Responses:

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Recoveries	6,556	30,281	13,593	7,479	-	57,909
Provision	117,629	49,061	350,444	97,188	235,678	850,000
Ending balance	\$ 1,491,716	\$ 4,124,295	\$ 1,243,410	\$ 868,486	\$ 415,737	\$ 8,143,644
Ending balance: individually evaluated for impairment	\$ 59,606	\$ 824,605	\$ 139,887	\$ 370,098		\$ 1,394,196
Ending balance: collectively evaluated for impairment	\$ 1,432,110	\$ 3,299,690	\$ 1,103,523	\$ 498,388		\$ 6,333,711
Loans receivable:						
Ending balance	\$ 83,445,470	\$ 163,311,472	\$ 86,220,659	\$ 73,353,722		\$ 406,331,323
Ending balance: individually evaluated for impairment	\$ 559,314	\$ 6,781,445	\$ 1,159,262	\$ 3,158,420		\$ 11,658,441
Ending balance: collectively evaluated for impairment	\$ 82,886,156	\$ 156,530,027	\$ 85,061,397	\$ 70,195,302		\$ 394,672,882

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As of and for the three months ended June 30, 2011:	Commercial & industrial	Commercial real estate	Consumer	Residential real estate	Unallocated	Total
Allowance for loan losses:						
Beginning balance	\$ 1,571,348	\$ 4,281,446	\$ 1,251,007	\$ 869,856	\$ 250,321	\$ 8,223,978
Charge-offs	-	193,319	302,504	-	-	495,823
Recoveries	2,706	30,035	7,748	-	-	40,489
Provision	(82,338)	6,133	287,159	(1,370)	165,416	375,000
Ending balance	\$ 1,491,716	\$ 4,124,295	\$ 1,243,410	\$ 868,486	\$ 415,737	\$ 8,143,644

As of and for the twelve months ended December 31, 2010:	Commercial & industrial	Commercial real estate	Consumer	Residential real estate	Unallocated	Total
Allowance for loan losses:						
Beginning balance	\$ 1,406,102	\$ 4,313,897	\$ 1,252,826	\$ 505,259	\$ 95,519	\$ 7,573,603
Charge-offs	451,979	892,426	462,815	1,813	-	1,809,033
Recoveries	3,839	2,799	39,904	1,710	-	48,252
Provision	409,569	814,002	419,391	357,498	84,540	2,085,000
Ending balance	\$ 1,367,531	\$ 4,238,272	\$ 1,249,306	\$ 862,654	\$ 180,059	\$ 7,897,822
Ending balance: individually evaluated for impairment	\$ -	\$ 528,505	\$ 116,458	\$ 362,764		\$ 1,007,727
Ending balance: collectively evaluated for impairment	\$ 1,367,531	\$ 3,709,767	\$ 1,132,848	\$ 499,890		\$ 6,710,036
Loans receivable:						
Ending balance	\$ 85,129,274	\$ 169,194,099	\$ 87,173,795	\$ 74,303,983		\$ 415,801,151
Ending balance: individually evaluated for impairment	\$ 164,583	\$ 4,768,369	\$ 1,135,872	\$ 3,899,851		\$ 9,968,675
Ending balance: collectively evaluated for impairment	\$ 84,964,691	\$ 164,425,730	\$ 86,037,923	\$ 70,404,132		\$ 405,832,476

Information related to the change in the allowance for loan losses as of June 30, 2010 is as follows:

	As of and for the three months ended June 30, 2010	As of and for the six months ended June 30, 2010
Allowance for loan losses:		
Beginning balance	\$ 7,751,589	\$ 7,573,603
Charge-offs	532,726	953,899
Recoveries	4,387	28,546
Provision	300,000	875,000
Ending balance	\$ 7,523,250	\$ 7,523,250

5. Earnings per share

Basic earnings per share (EPS) is computed by dividing income available to common shareholders by the weighted-average number of common stock outstanding for the period. Diluted EPS is computed in the same manner as basic EPS but reflects the potential dilution that could occur if stock options to issue additional common stock were exercised, which would then result in additional stock outstanding to share in or dilute the earnings of the Company. The Company maintains two share-based compensation plans that may generate additional potentially dilutive common shares. Generally, dilution would occur if Company-issued stock options were exercised and converted into common stock.

In the computation of diluted EPS, the Company uses the treasury stock method to determine the dilutive effect of its granted but unexercised stock options. Under the treasury stock method, the assumed proceeds received from shares issued, in a hypothetical stock option exercise, are assumed to be used to purchase treasury stock.

The following table illustrates the data used in computing basic EPS and a reconciliation to derive at the components of diluted EPS for the periods indicated:

	Three months ended June 30,		Six months ended June 30,	
	2011	2010	2011	2010
Basic EPS:				
Net income available to common shareholders	\$ 1,288,650	\$ 718,972	\$ 2,515,535	\$ 1,274,852
Weighted-average common shares outstanding	2,203,550	2,132,949	2,194,569	2,123,364
Basic EPS	\$ 0.59	\$ 0.34	\$ 1.15	\$ 0.60
Diluted EPS:				
Net income available to common shareholders	\$ 1,288,650	\$ 718,972	\$ 2,515,535	\$ 1,274,852
Weighted-average common shares outstanding	2,203,550	2,132,949	2,194,569	2,123,364
Potentially dilutive common shares	-	-	-	-
Weighted-average common shares and dilutive potential shares	2,203,550	2,132,949	2,194,569	2,123,364
Diluted EPS	\$ 0.59	\$ 0.34	\$ 1.15	\$ 0.60

There were no potentially dilutive shares outstanding in either period because the average share market price of the Company's common stock during the six months ended June 30, 2011 and 2010 was below the strike prices of all options granted. For a further discussion on the Company's stock option plans, see Note 6, "Stock plans," below.

6. Stock plans

The Company has two stock-based compensation plans (the stock option plans) and applies the fair value method of accounting for stock-based compensation provided under the current accounting guidance. The guidelines require the cost of share-based payment transactions (including those with employees and non-employees) be recognized in the financial statements. The stock option plans were shareholder-approved and permit the grant of share-based compensation awards to its directors, key officers and certain other employees. The Company believes that the stock option plans better align the interest of its directors, key officers and employees with the interest of its shareholders. The Company further believes that the granting of share-based awards is necessary to retain the knowledge base, continuity and expertise of its directors, key officers and employees. In the stock option plans, directors, key officers and certain other employees are eligible to be awarded stock options to purchase the Company's common stock at the fair market value on the date of grant.

The Company established the 2000 Independent Directors Stock Option Plan and has reserved 55,000 shares of its un-issued capital stock for issuance under the plan. No stock options were awarded during the six months ended June 30, 2011 and 2010. As of June 30, 2011, there were 18,300 unexercised stock options outstanding under this plan.

The Company also established the 2000 Stock Incentive Plan and has reserved 55,000 shares of its un-issued capital stock for issuance under the plan. There were no options awarded during the six months ended June 30, 2011 and 2010. As of June 30, 2011, there were 5,490 unexercised stock options outstanding under this plan.

No stock-based compensation expense was recognized, related to either of the stock option plans, since the Company did not grant stock options in 2011 or 2010.

The stock option plans expired in 2011 and as such no new options may be granted under the plans unless the Company extends the existing plans. The Company may choose to extend the plans or establish new stock option plans. Previously issued and currently outstanding options may be exercised pursuant to the terms of the stock option

plans existing at the time of grant. The extension or the establishment of a new plan will require shareholder approval. The Company is in the process of evaluating its decision to continue to maintain stock option plans.

In addition to the two stock option plans, the Company established the 2002 Employee Stock Purchase Plan (the ESPP) and reserved 110,000 shares of its un-issued capital stock for issuance. The plan was designed to promote broad-based employee ownership of the Company's stock and to motivate employees to improve job performance and enhance the financial results of the Company. Under the ESPP, employees use automatic payroll withholdings to purchase the Company's capital stock at a discounted price based on the fair market value of the capital stock as measured on either the commencement date or termination date. As of June 30, 2011, 21,826 shares have been issued under the ESPP. The ESPP is considered a compensatory plan and as such, is required to comply with the provisions of authoritative accounting guidance. The Company recognizes compensation expense on its ESPP on the date the shares are purchased. For the six months ended June 30, 2011 and 2010, compensation expense related to the ESPP approximated \$24,000 and \$7,000, respectively and is included as a component of salaries and employee benefits in the consolidated statements of income.

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7. Fair value measurements

The following table represents the carrying amount and estimated fair value of the Company's financial instruments as of the periods indicated (dollars in thousands):

	June 30, 2011		December 31, 2010	
	Carrying amount	Estimated fair value	Carrying amount	Estimated fair value
Financial assets:				
Cash and cash equivalents	\$46,676	\$46,676	\$22,967	\$22,967
Held-to-maturity securities	442	491	490	538
Available-for-sale securities	98,363	98,363	82,941	82,941
FHLB stock	4,099	4,099	4,542	4,542
Loans	398,188	395,974	407,903	402,174
Loans held-for-sale	485	493	213	217
Accrued interest	2,307	2,307	2,228	2,228
Financial liabilities:				
Deposit liabilities	506,927	503,694	482,448	478,721
Short-term borrowings	8,007	8,007	8,548	8,548
Long-term debt	21,000	23,927	21,000	23,956
Accrued interest	367	367	440	440

The following summarizes the methodology used to determine estimated fair values in the above table:

The carrying value of short-term financial instruments, as listed below, approximates their fair value. These instruments generally have limited credit exposure, no stated or short-term maturities and carry interest rates that approximate market.

- Cash and cash equivalents
- Non-interest bearing deposit accounts
- Savings, NOW and money market accounts
- Short-term borrowings
- Accrued interest

Securities: With the exception of pooled trust preferred securities, fair values on the other investment securities are determined by prices provided by a third-party vendor, who is a provider of financial market data, analytics and related services to financial institutions. The fair values of pooled trust preferred securities are determined based on a present value technique (income valuation) as described in Note 3, "Investment securities".

Loans: The fair value of loans is estimated by the net present value of the future expected cash flows discounted at current offering rates.

Loans held-for-sale (HFS): The fair value of loans HFS is estimated using rates currently offered for similar loans and is typically obtained from the Federal National Mortgage Association (FNMA) or the Federal Home Loan Bank of Pittsburgh (FHLB).

Certificates of deposit: The fair values of certificates of deposit accounts are based on discounted cash flows using rates which approximate market rates of deposits with similar maturities.

Long-term debt: The fair value of long-term debt is estimated using the rates currently offered for similar borrowings.

The accounting guidelines establish a framework for measuring and disclosing information about fair value measurements. The guidelines of fair value reporting instituted a valuation hierarchy for disclosure of the inputs used to measure fair value. This hierarchy prioritizes the inputs into three broad levels as follows:

Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities;

Level 2 inputs are quoted prices for similar assets and liabilities in active markets; quoted prices for identical or similar assets or liabilities in markets that are not active; or inputs that are observable for the asset or liability, either directly or indirectly through market corroboration, for substantially the full term of the financial instrument;

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Level 3 inputs are unobservable inputs based on the Company's own assumptions to measure assets and liabilities at fair value. Level 3 pricing for securities may also include unobservable inputs based upon broker-traded transactions.

A financial asset or liability's classification within the hierarchy is determined based on the lowest level input that is significant to the fair value measurement.

The Company uses fair value to measure certain assets and, if necessary, liabilities on a recurring basis when fair value is the primary measure for accounting. Thus, the Company uses fair value for AFS securities. Fair value is used on a non-recurring basis to measure certain assets when adjusting carrying values to market values, such as impaired loans and other real estate owned.

The following table illustrates the financial instruments measured at fair value on a recurring basis segregated by hierarchy fair value levels as of June 30, 2011 and December 31, 2010 (dollars in thousands):

	Total carrying value at June 30, 2011	Fair value measurements at June 30, 2011:		
		Quoted prices in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Assets:				
Available-for-sale securities:				
Agency - GSE	\$ 27,968	\$ -	\$ 27,968	\$ -
Obligations of states and political subdivisions	27,142	-	27,142	-
Corporate bonds:				
Pooled trust preferred securities	1,321	-	-	1,321
MBS - GSE residential	41,469	-	41,469	-
Equity securities - financial services	463	463	-	-
Total available-for-sale securities	\$ 98,363	\$ 463	\$ 96,579	\$ 1,321
	Total carrying value at December 31, 2010	Fair value measurements at December 31, 2010:		
		Quoted prices in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Assets:				
Available-for-sale securities:				
Agency - GSE	\$ 16,288	\$ -	\$ 16,288	\$ -
Obligations of states and political subdivisions	24,171	-	24,171	-
Corporate bonds:				
Pooled trust preferred securities	1,453	-	-	1,453
MBS - GSE residential	40,553	-	40,553	-
Equity securities - financial services	476	476	-	-
Total available-for-sale securities	\$ 82,941	\$ 476	\$ 81,012	\$ 1,453

Equity securities in the AFS portfolio are measured at fair value using quoted market prices for identical assets and are classified within Level 1 of the valuation hierarchy. Other than the Company's investment in corporate bonds, consisting of pooled trust preferred securities, all other debt securities in the AFS portfolio are measured at fair value

using market quotations provided by a third-party vendor, who is a provider of financial market data, analytics and related services to financial institutions. Assets classified as Level 2 use valuation techniques that are common to bond valuations. That is, in active markets whereby bonds of similar characteristics frequently trade, quotes for similar assets are obtained. For the six months ended June 30, 2011, there were no transfers to and from Level 1 and Level 2 fair value measurements for financial assets measured on a recurring basis.

The Company's pooled trust preferred securities include both observable and unobservable inputs to determine fair value and, therefore, are considered Level 3 inputs. The accounting pronouncement related to fair value measurement provides guidance on estimating fair value when the volume and level of activity for an asset or liability have significantly decreased in relation to normal market activity such as is the case with the Company's investment in pooled trust preferred securities. The requirements of fair value measurement also call for additional disclosures on fair value measurements and provide additional guidance on circumstances that may indicate that a transaction is not orderly. For a discussion on the fair value determination of the Company's investment in pooled trust preferred securities, see "Investment securities" under the caption "Comparison of Financial Condition at June 30, 2011 and December 31, 2010" in "Management's Discussion and Analysis of Financial Condition and Results of Operations," below.

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The following table illustrates the changes in Level 3 financial instruments, consisting of the Company's investment in pooled trust preferred securities, measured at fair value on a recurring basis for the periods indicated (dollars in thousands):

	As of and for the six months ended June 30, 2011	As of and for the six months ended June 30, 2010
Assets:		
Balance at beginning of period	\$ 1,453	\$ 5,242
Realized losses in earnings	(75)	(755)
Unrealized gains (losses) in OCI:		
Gains	206	1,009
Losses	(243)	(646)
Settlement	(28)	-
Interest paid-in kind	6	-
Accretion	2	-
Purchases, sales, issuances and settlements, amortization, and accretion, net	-	70
Balance at end of period	\$ 1,321	\$ 4,920

The following table illustrates the financial instruments measured at fair value on a non-recurring basis segregated by hierarchy fair value levels as of the periods indicated (dollars in thousands):

	Total carrying value at June 30, 2011	Fair value measurements at June 30, 2011		
		Quoted prices in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Assets:				
Impaired loans	\$ 4,728	\$ -	\$ -	\$ 4,728
Other real estate owned	847	-	-	847
Total	\$ 5,575	\$ -	\$ -	\$ 5,575
	Total carrying value at December 31, 2010	Fair value measurements at December 31, 2010		
		Quoted prices in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Assets:				
Impaired loans	\$ 4,453	\$ -	\$ -	\$ 4,453
Other real estate owned	1,261	-	-	1,261
Total	\$ 5,714	\$ -	\$ -	\$ 5,714

From time-to-time, the Company may be required to record at fair value financial instruments on a non-recurring basis, such as impaired loans and other real estate owned (ORE). These non-recurring fair value adjustments involve the application of lower-of-cost-or-market accounting or write downs of individual assets.

The following describes valuation methodologies used for financial instrument measured at fair value on a non-recurring basis.

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A loan is considered impaired when, based upon current information and events, it is probable that Company will be unable to collect all scheduled payments in accordance with the contractual terms of the loan. Impaired loans that are collateral dependent are written down to fair value through the establishment of specific reserves, a component of the allowance for loan losses, and as such are carried at the lower of net recorded investment or the estimated fair value. Estimates of fair value of the collateral is determined based on a variety of information, including available valuations from certified appraisers for similar assets, present value of discounted cash flows and inputs that are estimated based on commonly used and generally accepted industry liquidation advance rates and estimates and assumptions developed by management. Management's assumptions may include consideration of location and occupancy of the property and current economic conditions. Because of the multitude of assumptions, many of which are subjective in nature, and the varying inputs and techniques used by appraisers, the Company recognizes that valuations could differ across a wide spectrum of valuation techniques employed and accordingly, fair value estimates for impaired loans are classified as Level 3.

The fair value for ORE is estimated in the same manner as impaired loans and, as such, is also classified as Level 3. As these properties are actively marketed, the estimated fair values may be periodically adjusted through incremental subsequent write-downs to reflect decreases in estimated values resulting from sales price observations and the impact of changing economic and market conditions.

Management of the Company concluded that the inputs used to determine fair value of its non-recurring financial instruments, including valuations received from third party certified appraisers, industry standard liquidation rates and other subjective inputs from management, contain a number of assumptions that are unobservable in the marketplace. Though management has not altered the methodology to determine fair value, for comparative purposes the amounts indicated as Level 2 inputs as of December 31, 2010 were reclassified as Level 3 inputs.

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

The following is management's discussion and analysis of the significant changes in the consolidated financial condition of the Company as of June 30, 2011 compared to December 31, 2010 and a comparison of the results of operations for the three- and six-months ended June 30, 2011 and 2010. Current performance may not be indicative of future results. This discussion should be read in conjunction with the Company's 2010 Annual Report filed on Form 10-K.

Forward-looking statements

Certain of the matters discussed in this Quarterly Report on Form 10-Q may constitute forward-looking statements for purposes of the Securities Act of 1933, as amended, and the Securities Exchange Act of 1934, as amended, and as such may involve known and unknown risks, uncertainties and other factors which may cause the actual results, performance or achievements of the Company to be materially different from future results, performance or achievements expressed or implied by such forward-looking statements. The words "expect," "anticipate," "intend," "plan," "believe," "estimate," and similar expressions are intended to identify such forward-looking statements.

The Company's actual results may differ materially from the results anticipated in these forward-looking statements due to a variety of factors, including, without limitation:

- § the effects of economic deterioration on current customers, specifically the effect of the economy on loan customers' ability to repay loans;
- § the costs and effects of litigation and of unexpected or adverse outcomes in such litigation;
- § the impact of new laws and regulations, including the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 and the regulations promulgated there under;

- § governmental monetary and fiscal policies, as well as legislative and regulatory changes;
- § the effect of changes in accounting policies and practices, as may be adopted by the regulatory agencies, as well as the Financial Accounting Standards Board and other accounting standard setters;
- § 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 rate protection agreements, as well as interest rate risks;
- § 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 the Company's market area and elsewhere, including institutions operating locally, regionally, nationally and internationally, together with such competitors offering banking products and services by mail, telephone, computer and the internet;
- § technological changes;
- § acquisitions and integration of acquired businesses;
- § the failure of assumptions underlying the establishment of reserves for loan losses and estimations of values of collateral and various financial assets and liabilities;
- § volatilities in the securities markets;
- § deteriorating economic conditions;
- § disruption of credit and equity markets; and

§ acts of war or terrorism.

The Company cautions readers not to place undue reliance on forward-looking statements, which reflect analyses only as of the date of this document. We have no obligation to update any forward-looking statements to reflect events or circumstances after the date of this document.

Readers should review the risk factors described in other documents that we file or furnish, from time to time, with the Securities and Exchange Commission, including Annual Reports to Shareholders, Annual Reports filed on Form 10-K and other current reports filed or furnished on Form 8-K.

General

The Company's results of operations depend primarily on net interest income. Net interest income is the difference between interest income and interest expense. Interest income is generated from yields on interest-earning assets, which consist principally of loans and investment securities. Interest expense is incurred from rates paid on interest-bearing liabilities, which consist of deposits and borrowings. Net interest income is determined by the Company's interest rate spread (the difference between the yields earned on its interest-earning assets and the rates paid on its interest-bearing liabilities) and the relative amounts of interest-earning assets and interest-bearing liabilities. Interest rate spread is significantly impacted by: changes in interest rates and market yield curves and their related impact on cash flows; the composition and characteristics of interest-earning assets and interest-bearing liabilities; differences in the maturity and re-pricing characteristics of assets compared to the maturity and re-pricing characteristics of the liabilities that fund them and by the competition in the marketplace.

The Company's profitability is also affected by the level of its non-interest income and expenses and by the provisions for loan losses income taxes. Non-interest income consists mostly of service charges on the Company's loan and deposit products, trust and asset management service fees, increases in the cash surrender value of the bank owned life insurance, net gains or losses from sales of loans, securities and foreclosed assets held-for-sale and from credit-related other-than-temporary impairment (OTTI) charges on investment securities. Non-interest expense consists of compensation and related employee benefit expenses, occupancy, equipment, data processing, advertising, marketing, FDIC insurance premiums, professional fees, supplies and other operating overhead.

The Company's profitability is significantly affected by general economic and competitive conditions, changes in market interest rates, government policies and actions of regulatory authorities. The Company's loan portfolio is comprised principally of commercial and commercial real estate loans. The properties underlying the Company's mortgages are concentrated in Northeastern Pennsylvania. Credit risk, which represents the possibility of the Company not recovering amounts due from its borrowers, is significantly related to local economic conditions in the areas where the properties are located as well as the Company's underwriting standards. Economic conditions affect the market value of the underlying collateral as well as the levels of adequate cash flow and revenue generation from income-producing commercial properties.

Comparison of the results of operations Three- and six-months ended June 30, 2011 and 2010

Overview

Net income for the second quarter of 2011 was \$1,289,000, or \$0.59 per diluted share compared to \$719,000, or \$0.34 per diluted share, recorded in the same quarter of 2010. For the six months ended June 30, 2011, net income was \$2,516,000, or \$1.15 per diluted share compared to \$1,275,000, or \$0.60 per diluted share, recorded for the six months ended June 30, 2010. The increase in net income in the quarter and year-to-date periods was due to: an increase in

non-interest income, most notably from significantly lower non-cash, other-than-temporary impairment (OTTI) charges related to the Company's investment portfolio, higher net interest income and lower expenses including the provision for loan losses. These items were partially offset by higher provision for income taxes recorded in both periods.

Return on average assets (ROA) and return on average shareholders' equity (ROE) were 0.87% and 10.44%, respectively, for the three months ended June 30, 2011 compared to 0.49% and 6.10%, respectively, for the three months ended June 30, 2010. For the six months ended June 30, 2011, ROA and ROE were 0.86% and 10.43%, respectively, compared to 0.44% and 5.48% for the same period in 2010. The improvements in ROA and ROE for both comparable periods are attributable to higher net income.

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Net interest income and interest sensitive assets / liabilities

Net interest income increased \$100,000, or 2%, in the second quarter of 2011 to \$5,317,000, from \$5,217,000 recorded in the second quarter of 2010. The increase was caused by a larger decline in interest expense than interest income. Compared to the second quarter of 2010, interest expense declined \$473,000, or 27%, in the second quarter of 2011. The factors contributing to the lower interest expense were lower rates paid on interest-bearing deposits that helped reduce the expense by \$256,000, and lower balances of high-cost borrowings equating to a reduction of \$217,000. The lower rate environment caused deposits to price 27 basis points below the deposit pricing that was in effect in the year-ago quarter. The lower interest expense from borrowings was due principally from the payoff of \$20,500,000 in short- and long-term FHLB advances in the fourth quarter of 2010. The effect of the lower average balances of borrowings was the principal cause of interest expense on borrowings to decline \$188,000, or 41%, in the second quarter of 2011 compared to the second quarter of 2010. Compared to the second quarter of 2010, interest income declined \$373,000, or 5%, from \$6,970,000 recorded in the second quarter of 2010 compared to \$6,597,000 recorded during the second quarter of 2011. The decline in interest income was due principally from a 60 basis point decrease in yields from the Company's investment portfolio, as well as a \$15,800,000 net decline in the average balances of the loan portfolio, predominantly from commercial loans caused by payoffs and the risk management practice to strategically reduce their balances. The decline in yield in the investment portfolio was caused by the defaults in preferred term securities and their related migration to non-accrual status and lower yields earned from the added mortgage-backed and government agency securities.

For the six months ended June 30, 2011, net interest income increased \$175,000, or 2%, from \$10,376,000 in the first half of 2010 to \$10,551,000 in the first half of 2011. Similar to the second quarter the decline in interest expense was greater than the decline in interest income producing the higher level of net interest income. Interest expense declined \$1,039,000, or 29%, in the six months ended June 30, 2011 compared to the six months ended June 30, 2010. Rates paid on interest-bearing deposits were 31 basis points lower in the current year period compared to 2010, which had the effect of a \$572,000 reduction in interest expense. In addition the previously noted debt reduction during the fourth quarter of 2010 helped reduce interest expense from borrowings by \$382,000 in first half of 2011. The impact of lower rates paid and balances of interest-bearing liabilities was only partially offset by an \$864,000, or 6%, decrease in interest income during the six months ended June 30, 2011 compared to the six months ended June 30, 2010. The lower average commercial loan portfolio and the impact of a 69 basis point reduction in yields earned from investments were the principal cause of lower interest income.

The Company's tax-equivalent margin and spread improved to 4.01% and 3.75%, respectively, for the three months ended June 30, 2011 from 3.92% and 3.66% during the same period of 2010. For the first half of 2011, the margin and spread improved to 4.03% and 3.76% from 3.91% and 3.64%, respectively, in the first half of 2010. In the quarter comparison, the improvement in spread is from a more rapid decline in rates paid on interest-costing liabilities compared to the decline in yields from interest-earning assets. The improved margin is from the higher spread on a relatively stable portfolio of average interest-earning assets. In the year-to-date comparison, the improved margin was caused by higher net interest income and lower average interest-earning assets.

Yield performance from interest-sensitive assets is significantly impacted during periods of declining and prolonged low interest rate environments. The cost of funds during the same periods also declined in response to declines in market rates. The historically low interest rate environment, which has been significantly influenced by the Fed Funds rate of 0.0% to 0.25% set by the Federal Reserve in the fourth quarter of 2008, has benefited the Company's net interest income as the Company responded by managing its cost of funds which has decreased more rapidly than the decrease in the yields earned on its interest-earning assets. We do not expect to continue to benefit significantly from the downward re-pricing of our interest-bearing liabilities and as such our net interest margin may begin to experience downward pressure in the near-term.

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The following table sets forth a comparison of average balances and their corresponding fully tax-equivalent (FTE) interest income and expense and annualized tax-equivalent yield and cost for the periods indicated (dollars in thousands):

	June 30, 2011		Three months ended:			
	Average balance	Interest	Yield / rate	Average balance	Interest	Yield / rate
Assets						
Interest-earning assets:						
Loans and leases	\$416,402	\$5,962	5.74 %	\$432,214	\$6,237	5.79 %
Investments	102,758	833	3.25	99,663	925	3.72
Federal funds sold	468	-	0.25	10,210	6	0.25
Interest-bearing deposits	33,977	21	0.25	12,482	8	0.25
Total interest-earning assets	553,605	6,816	4.94	554,569	7,176	5.19
Non-interest-earning assets	38,815			30,880		
Total assets	\$592,420			\$585,449		
Liabilities and shareholders' equity						
Interest-bearing liabilities:						
Other interest-bearing deposits	\$266,038	\$315	0.47 %	\$263,717	\$473	0.72 %
Certificates of deposit	135,751	700	2.07	143,416	827	2.31
Borrowed funds	21,731	259	4.77	42,014	428	4.09
Repurchase agreements	7,449	6	0.35	11,309	25	0.90
Total interest-bearing liabilities	430,969	1,280	1.19	460,456	1,753	1.53
Non-interest-bearing deposits	108,882			74,101		
Other non-interest-bearing liabilities	3,049			3,618		
Shareholders' equity	49,520			47,274		
Total liabilities and shareholders' equity	\$592,420			\$585,449		
Net interest income / interest rate spread		\$5,536	3.75 %		\$5,423	3.66 %
Net interest margin			4.01 %			3.92 %

	June 30, 2011		Six months ended:			
	Average balance	Interest	Yield / rate	Average balance	Interest	Yield / rate
Assets						
Interest-earning assets:						
Loans and leases	\$417,797	\$11,962	5.77 %	\$434,693	\$12,540	5.82 %
Investments	100,123	1,574	3.17	96,316	1,848	3.87
Federal funds sold	276	-	0.25	11,540	13	0.23
Interest-bearing deposits	30,945	39	0.25	12,942	16	0.25
Total interest-earning assets	549,141	13,575	4.98	555,491	14,417	5.23
Non-interest-earning assets	37,934			31,406		
Total assets	\$587,075			\$586,897		

Explanation of Responses:

Liabilities and shareholders' equity
Interest-bearing liabilities:

Other interest-bearing deposits	\$259,199	\$612	0.96	%	\$260,481	\$979	0.76	%
Certificates of deposit	137,803	1,445	4.25		144,892	1,735	2.41	
Borrowed funds	21,740	514	4.77		42,028	851	4.08	
Repurchase agreements	11,098	26	0.46		14,642	70	0.97	
Total interest-bearing liabilities	429,840	2,597	1.22		462,043	3,635	1.59	
Non-interest-bearing deposits	105,431				74,452			
Other non-interest-bearing liabilities	3,152				3,499			
Shareholders' equity	48,652				46,903			
Total liabilities and shareholders' equity	\$587,075				\$586,897			
Net interest income/interest rate spread		\$10,978	3.76	%		\$10,782	3.64	%
Net interest margin			4.03	%			3.91	%

In the preceding table, interest income was adjusted to a tax-equivalent basis, using the corporate federal tax rate of 34%, to recognize the income from tax-exempt interest-earning assets as if the interest was taxable. This treatment allows a uniform comparison between yields on interest-earning assets. Loans include loans HFS and non-accrual loans but exclude the allowance for loan losses. Securities include non-accrual securities. Average balances are based on amortized cost and do not reflect net unrealized gains or losses. Net interest margin is calculated by dividing net interest income by total average interest-earning assets.

The prevalent low interest rate environment has been causing yields from earning assets to contract and will continue to do so thereby asserting continued downward pressure on the Company's interest rate margin. The Company's Asset Liability Management (ALM) team meets regularly to discuss among other things, interest rate risk and when deemed necessary adjusts interest rates on deposits and repurchase agreements to help mitigate the decline in interest income. This initiative helps stabilize net interest income at acceptable margins. The Company's deposit offering rates are at historical lows and whether the Company can retain and grow its deposit base will largely depend on customers' sentiment to maintain low-earning deposits. The Company's marketing department, in concert with ALM, lending and deposit gatherers, is formulating prudent, tactical plans that will grow the loan portfolio and help continue to accumulate low-cost deposits in order to maintain a healthy interest rate margin.

Provision for loan losses

The provision for loan losses represents the necessary amount to charge against current earnings, the purpose of which is to increase the allowance for loan losses to a level that represents management's best estimate of known and inherent losses in the Company's loan portfolio. Loans determined to be uncollectible are charged off against the allowance for loan losses. The required amount of the provision for loan losses, based upon the adequate level of the allowance for loan losses, is subject to ongoing analysis of the loan portfolio. The Company's Special Assets Committee meets periodically to review problem loans. The committee is comprised of management, including the senior loan officer, the chief risk officer, loan officers, loan workout officers and collection personnel. The committee reports quarterly to the Credit Administration Committee of the Board of Directors.

Management continuously reviews the risks inherent in the loan portfolio. Specific factors used to evaluate the adequacy of the loan loss provision during the formal process include:

- specific loans that could have loss potential;
- levels of and trends in delinquencies and non-accrual loans;
- levels of and trends in charge-offs and recoveries;
- trends in volume and terms of loans;
- changes in risk selection and underwriting standards;
- changes in lending policies, procedures and practices;
- experience, ability and depth of lending management;
- national and local economic trends and conditions; and
- changes in credit concentrations.

The provision for loan losses was \$850,000 for the six months ending June 30, 2011 and was \$875,000 for the six month period ending June 30, 2010. The provision for the three months ending June 30, 2011 was \$375,000 and was \$300,000 for the same three month period ending June 30, 2010. The \$375,000 provision for the current quarter was predominantly recorded to provide for the uncertainties associated with the continuing stagnant economy.

The allowance for loan losses was \$8,144,000 at June 30, 2011 compared to \$7,898,000 at December 31, 2010. For a further discussion on the allowance for loan losses, see "Allowance for loan losses" under the caption "Comparison of financial condition at June 30, 2011 and December 31, 2010" below.

Other income

For the three months ended June 30, 2011, non-interest income amounted to \$1,398,000 compared to \$640,000 in the same 2010 quarter – more than doubling the prior year quarter. The improvement in non-interest income was from no credit-related OTTI charges on the Company's investments in pooled trust preferred securities required in the 2011 quarter, compared to \$676,000 of impairment recorded in the second quarter of 2010. See Note 3, "Investment

securities,” in the consolidated financial statements, for a further discussion on the Company’s investments in pooled trust preferred securities and the impairment related thereto. Furthermore, the Company’s core banking business generated enough fee income to offset declines in gains recognized in the sale of residential mortgages as well as \$66,000 of write-downs on newly appraised foreclosed properties held for sale. Healthy fees generated by the Company’s financial services and trust departments helped boost other fees and revenues by \$134,000, or 56%, in the current year quarter compared to the second quarter of 2010. A lower volume of residential lending activity resulted in a \$37,000, or 28%, decline in recognized gains.

For the six months ended June 30, 2011, non-interest income increased \$950,000, or 53%, from \$1,786,000 recorded in the first half of 2010 to \$2,736,000 recorded in the six months ended June 30, 2011. During the first half of 2010, the Company was required to record credit-related OTTI of \$755,000 compared to only \$75,000 required for the first half of 2011. In addition and similar to the second quarter’s performance, strong fee income generated from the Company’s financial services and trust units helped increase other fees and revenues by \$179,000, or 33%, in 2011 compared to 2010. The gain recognized from the sale of a Small Business Administration commercial loan of \$90,000 was the cause of the higher gains from the sales of loans.

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Other operating expenses

Other operating expenses declined \$74,000, or 2%, in the second quarter of 2011 compared to the second quarter of 2010. Salary and employee benefits decreased \$38,000, or 2%, for the three months ended June 30, 2011 compared to the same period of 2010. The decline was due to lower payroll taxes from less salaries as well as more deferred payroll costs associated with the lending function. The 2011 quarter was reflective of an increase in the per-unit cost deferral. The lower amount of advertising and marketing expenses, \$72,000 or 27%, was due to the non-recurring nature of costs incurred during 2010. Loan collection and other real estate (ORE) expenses declined, net \$78,000, or 34%, due primarily to fewer problematic loans requiring extensive legal representation offset somewhat by higher costs to maintain the Company's foreclosed properties currently for sale. The increase in professional services stems from higher cost incurred for services provided from legal and professional trust services and the new costs to comply with the new SEC eXtensible Business Reporting Language, or XBRL, reporting requirements. The \$72,000, or 8%, increase in premises and equipment was from higher facilities maintenance and also from higher levels of amortization of leasehold improvements in conjunction with expenditures consummated in 2010 for branch upgrades.

For the six months ended June 30, 2011, other operating expenses declined \$689,000, or 7%, from \$9,799,000 for the first half of 2010 to \$9,110,000 for the first half of 2011. Salary and employee benefits decreased \$583,000, or 12%, during the 2011 period. The 2010 figure included \$398,000 in one-time severance and voluntary termination payout caused by the planned, structured reorganization of the Company. This cost did not recur in 2011. The average number of full-time equivalent (FTE) employees for the six months ended June 30, 2011 was 158 compared to 172 average FTEs during the six months ended June 30, 2010. Loan collection and ORE expenses decreased \$191,000, or 49%, during the current year period compared to the same period of 2010. In 2010, the Company incurred higher collection related expenses in order to resolve more problematic loans. The \$81,000, or 19%, decline in advertising and marketing was caused by the aforementioned non-recurring costs. The \$153,000, or 9%, increase in premises and equipment was the result of higher utility costs, expenses associated with facilities maintenance from the region's prolonged severe weather conditions during the first quarter of this year, compared to 2010 and increased amortization of leasehold improvements from expenditures incurred during 2010 for branch upgrades.

Provision for income taxes

The higher effective tax rate for the three- and six- months ended June 30, 2011 of 25.1% and 24.4% compared to the three- and six- months ended June 30, 2010 of 16.7% and 14.4%, respectively was due to a much higher level of pre-tax earnings upon which the corporate income tax rate of 34% was applied.

Comparison of financial condition at June 30, 2011 and December 31, 2010

Overview

Consolidated assets increased \$27,011,000 to \$588,684,000 or 5%, as of June 30, 2011 from \$561,673,000 at December 31, 2010. The increase was from \$24,480,000 growth in deposits and a \$3,572,000 increase in shareholders' equity.

Investment securities

At the time of purchase, management classifies investment securities into one of three categories: trading, available-for-sale (AFS) or held-to-maturity (HTM). To date, management has not purchased any securities for trading purposes. Most of the securities the Company purchases are classified as AFS even though there is no immediate intent to sell them. The AFS designation affords management the flexibility to sell securities and position

Explanation of Responses:

the balance sheet in response to capital levels, liquidity needs or changes in market conditions. Securities AFS are carried at fair value in the consolidated balance sheet with an adjustment to shareholders' equity, net of tax, presented under the caption "Accumulated other comprehensive income (loss)." Securities designated as HTM are carried at amortized cost and represent debt securities that the Company has the ability and intent to hold until maturity.

As of June 30, 2011, the carrying value of investment securities amounted to \$98,805,000, or 17% of total assets, compared to \$83,431,000, or 15% of total assets, at December 31, 2010. On June 30, 2011, approximately 42% of the carrying value of the investment portfolio was comprised of U.S. Government Sponsored Enterprise residential mortgage-backed securities (MBS – GSE residential or mortgage-backed securities) that amortize and provide monthly cash flow.

As of June 30, 2011, investment securities were comprised of HTM and AFS securities with carrying values of \$442,000 and \$98,363,000, respectively. The AFS debt securities were recorded with a net unrealized loss in the amount of \$3,720,000 and equity securities were recorded with an unrealized gain of \$150,000, compared to \$5,937,000 and \$154,000, respectively as of December 31, 2010, or a net improvement of \$2,113,000.

The Company's investment policy is designed to complement its lending activity. During the six months ended June 30, 2011, the carrying value of total investments increased \$15,374,000. The Company uses cash flow generated from mortgage-backed securities pay downs, bond calls, as well as excess cash to invest, re-invest and advantageously diversify the securities portfolio in response to market conditions, interest rate environments, the performance of other interest-earning assets, interest rate risk, credit risk and anticipated liquidity needs.

A comparison of investment securities at June 30, 2011 and December 31, 2010 is as follows (dollars in thousands):

	June 30, 2011		December 31, 2010	
	Amount	%	Amount	%
MBS - GSE residential	\$ 41,911	42.4	\$ 41,043	49.2
State & municipal subdivisions	27,142	27.5	24,171	29.0
Agency - GSE	27,968	28.3	16,288	19.5
Pooled trust preferred securities	1,321	1.3	1,453	1.7
Equity securities - financial services	463	0.5	476	0.6
Total investments	\$ 98,805	100.0	\$ 83,431	100.0

Quarterly, management performs a review of the investment portfolio to determine the cause of declines in the fair value of each security. The Company uses inputs provided by independent third parties to determine the fair value of its investment securities portfolio. Inputs provided by the third party are reviewed and corroborated by management. Evaluations of the causes of the unrealized losses are performed to determine whether impairment is temporary or other-than-temporary. Considerations such as the Company's intent and ability to hold the securities to maturity, recoverability of the invested amounts over the intended holding period, the length of time and the severity in pricing decline below cost, the interest rate environment, the receipt of amounts contractually due and whether or not there is an active market for the security, for example, are applied, along with the financial condition of the issuer for management to make a realistic judgment of the probability that the Company will be unable to collect all amounts (principal and interest) due in determining whether a security is other than temporarily impaired. If a decline in value is deemed to be other-than-temporary, the amortized cost of the security is reduced by the credit impairment amount and a corresponding charge to earnings is recognized. If at the time of sale, call or maturity the proceeds exceed the security's amortized cost, the impairment charge may be fully or partially recovered.

The Company owns 13 tranches of pooled trust preferred securities (PreTSLs). The market for these securities and other issues of PreTSLs at June 30, 2011 remained inactive. The inactivity was evidenced first by a significant widening of the bid-ask spread in the brokered markets in which PreTSLs trade, then by a significant decrease in the volume of trades relative to historical levels and the lack of a new-issue market since 2007. There are currently very few market participants who are willing and/or able to transact for these securities. Given the conditions in the debt markets and in the absence of observable transactions in the secondary and a new-issue market, management has made the following observations and has determined:

- The few observable transactions and market quotations that were available were not reliable for purposes of determining fair value at June 30, 2011;
- An income valuation approach (present value technique) that maximizes the use of relevant observable market inputs and minimizes the use of unobservable inputs are equally or more representative of fair value than the market approach valuation technique; and
- The 13 PreTSLs are classified within "Level 3" (as defined in current accounting guidance and explained in Note 7, "Fair value measurements" of the consolidated financial statements) of the fair value hierarchy because significant adjustments are required to determine fair value at the measurement date. The Company engages an independent third party that is a structured products specialist firm, to analyze the PreTSL portfolio. The approach and results were reviewed and corroborated by management. The approach to determine OTTI involves the following:
 - o Data about the transaction structure, as defined in the offering documents and the underlying collateral, were collected;

- oThe credit worthiness of each collateral is determined by reviewing the obligor and estimating the credit risk existing or inherent for such obligor;
- oUsing the credit risk estimates and making assumptions about default correlation, simulate 10,000 Monte Carlo scenarios (a class of computational algorithms that rely on repeated random sampling to compute their results) with respect to default timing for each security;
- oProject tranche cash flows over 10,000 Monte Carlo scenarios; determine the percentage of the total scenarios that result in a loss to the tranche. If the number of scenarios resulting in a loss exceeded 50%, OTTI is presumed to exist;

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- o Utilize several high-level financial factors to construct an appropriate discount rate for each tranche within each transaction. Factors include the portfolio's weighted average credit rating, the average life of the collateral pool, the Bloomberg US Bank Benchmark discount rate, an appropriate spread differential to account for the rating assumed by the Bloomberg US Bank Benchmark and the actual average rating of the collateral pool. Lastly, credit loss already assumed under Monte Carlo simulation is subtracted from the discount rate construction in the previous step to avoid double-counting of credit risk;
 - o With an appropriate discount rate for each tranche, an appropriate book price is determined;
- o With a projected discount rate, an estimated cash flow test was performed on each issue to compare the present value of the currently estimated cash flows as of June 30, 2011 to the amount projected as of the last measurement date, March 31, 2011;
- o If the results of the cash flow tests resulted in a significant adverse change in projected cash flows, credit-related OTTI is present.

Based on the technique described, the Company determined that for the three months ended June 30, 2011 there were no significant adverse changes in projected cash flows in the issues and therefore has concluded that credit-related OTTI was non-existent during the second quarter of 2011. Utilizing the same technique at March 31, 2011, the Company determined that the amortized cost of one PreTSL – XXIV had declined \$75,000 in total during the first three months of 2011 and since the present value of the security's expected cash flows were insufficient to recover the entire amortized cost, the security is deemed to have experienced credit-related OTTI in the amount of \$75,000 which was charged to current earnings as a component of other income in the consolidated statement of income for the six months ended June 30, 2011. Future analyses could yield results that may indicate further impairment has occurred and would therefore require additional write-downs and corresponding OTTI charges to current earnings. For more information about OTTI charges, see Note 3, "Investment securities" of the consolidated financial statements.

Federal Home Loan Bank Stock

In order to gain access to the low-cost products and services offered by the FHLB, investment in FHLB stock is required for membership in the organization and is carried at cost since there is no market value available. The amount the Company is required to invest is dependent upon the relative size of outstanding borrowings the Company has with the FHLB. Excess stock is typically repurchased from the Company at par if the level of borrowings declines to a predetermined level. In addition, the Company normally earns a return or dividend on the amount invested.

In order to preserve its capital, in December 2008 the FHLB declared a suspension on the redemption of its stock and ceased payment of quarterly dividends until such time it becomes prudent to reinstate either or both. During the fourth quarter of 2010 and again in the first half of 2011, the FHLB announced a partial lifting and limited repurchase of the stock redemption provision of the suspension. As a result, the Company was able to redeem \$239,000 of its FHLB stock in the fourth quarter of 2010 and an additional \$443,000 in the first half of 2011. The dividend suspension remains in effect. Future redemptions and dividend payments will be predicated on the financial performance and health of the FHLB. Based on the financial results of the FHLB for the six months ended June 30, 2011 and for the year-ended December 31, 2010, management believes that the suspension of both the dividend payments and excess capital stock repurchase is temporary in nature. Management continues to believe that the FHLB will continue to be a primary source of wholesale liquidity for both short- and long-term funding and has concluded that its investment in FHLB stock is not other-than-temporarily impaired. There can be no assurance, however, that future negative changes to the financial condition of the FHLB may not require the Company to recognize an impairment charge with respect to such holdings. The Company will continue to monitor the financial condition of the FHLB and assess its future ability to resume normal, scheduled dividend payments and normal stock redemption activities.

Loans held-for-sale (HFS)

Upon origination, certain residential mortgages are classified as HFS. In the event of market rate increases, fixed-rate loans and loans not immediately scheduled to re-price would no longer produce yields consistent with the current market. In a low interest rate environment, the Company would be exposed to prepayment risk and, as rates on adjustable-rate loans decrease, interest income would be negatively affected. Consideration is given to the Company's current liquidity position and projected future liquidity needs. To better manage prepayment and interest rate risk, loans that meet these conditions may be classified as HFS. The carrying value of loans HFS is at the lower of cost or estimated fair value. If the fair values of these loans fall below their original cost, the difference is written down and charged to current earnings. Subsequent appreciation in the portfolio is credited to current earnings but only to the extent of previous write-downs.

As of June 30, 2011, Loans HFS amounted to \$485,000 with a corresponding fair value of \$493,000, compared to \$213,000 and \$217,000, respectively, at December 31, 2010. During the six months ended June 30, 2011, residential mortgage loans with principal balances of \$13,505,000 were sold into the secondary market with net gains of approximately \$248,000 recognized, compared to \$18,902,000 and \$229,000, respectively, during the six months ended June 30, 2010.

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Loans

The Company originates commercial and industrial (commercial), commercial real estate (CRE), residential mortgages, consumer, home equity and construction loans. The relative volume of originations is dependent upon customer demand, current interest rates and the perception and duration of future interest levels. As part of the overall strategy to serve the business community in which it operates, the Company is focused on developing and implementing products and services to the broad spectrum of businesses that operate in its marketplace. The Company's goals center on building relationships by providing credit and cash management products and services, continuing to diversify its loan portfolio and utilizing loan participations to reduce risk in larger credit transactions. A loan participation is a tool that allows a community bank to meet the needs of its local customer base. Certain customers, from time-to-time, may require funding that is out of the lending limit of a local community bank. In such circumstances, it allows a bank to originate the loan, and subsequently sell a portion, or portions, of that loan to other financial institutions, thereby mitigating the risk the Company will take on with one loan. These sold portions of the loan are referred to as loan participations.

The policies, procedures and credit risk of the Company are reflective of the current economy. The risks associated with interest rates are being managed by utilizing floating versus long-term fixed rates, as well as government sponsored programs through the Federal Home Loan Bank and, as noted above, utilizing participations to mitigate interest rate risk.

Commercial and industrial

The commercial and industrial portfolio decreased \$1,684,000, or 2%, to \$83,445,000 during the first six months of 2011. There was an \$8,000,000 payoff during the second quarter of 2011 which was partially offset by an increase in tax anticipation facilities, which was one of several factors for the decrease in this portfolio. Other factors can be attributed to a reduction in demand; difficulty for current and prospective clients to adhere to the Company's underwriting policies and procedures, and a general lack of economic growth within the Company's marketplace. Based upon maturities and scheduled payoffs, it is likely that this portfolio reduction will continue through the third quarter of 2011.

Commercial real estate

The commercial real estate portfolio declined \$5,882,000, or 3%, from \$169,194,000 at December 31, 2010 to \$163,312,000 as of June 30, 2011. There was a substantial payoff during the second quarter, for which the Company had an opportunity to continue the relationship, but due to several factors, including rates, that the Company considered unacceptable, the relationship was not renewed. This was a significant factor in the decrease. In addition, concerns associated with the non-owner occupied commercial real estate market, as well as the depressed commercial real estate market, as a whole, within our service area, and an overall general lack of activity are additional reasons for this reduction.

Residential

The residential portfolio has decreased \$951,000 since December 31, 2010. The factors contributing to this decrease are attributable primarily to a decrease in the residential construction portfolio of \$3,064,000, which was partially offset by an increase in the residential real estate portfolio of \$2,113,000. The decrease in residential construction is a result of these loans converting to traditional residential real estate mortgages. In residential real estate, the Company has begun, and will continue to, originate fixed rate mortgages with a maximum term of 15 years for portfolio. The object of this strategy being to increase net interest margin, to enhance capital through an extended earnings stream, and limit exposure from a credit risk point of view through utilizing underwriting standards that are conforming to the

secondary market.

Consumer loans

Consumer loans declined \$953,000, or 1%, during the first six months of 2011. Though a modest decline, the Company's intention for 2011 is to expand this segment and grow the portfolio, while maintaining asset quality.

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The composition of the loan portfolio at June 30, 2011 and December 31, 2010, is summarized as follows (dollars in thousands):

	June 30, 2011		December 31, 2010		Variance	%
	Amount	%	Amount	%		
Commercial and industrial	\$83,445	20.5	\$85,129	20.5	\$(1,684)	(2.0)
Commercial real estate:						
Non-owner occupied	80,981	19.9	87,355	21.0	(6,374)	(7.3)
Owner occupied	68,994	17.0	69,338	16.7	(344)	(0.5)
Construction	13,337	3.3	12,501	3.0	836	6.7
Consumer:						
Home equity installment	38,034	9.4	40,089	9.6	(2,055)	(5.1)
Home equity line of credit	30,520	7.5	29,185	7.0	1,335	4.6
Auto	11,432	2.8	10,734	2.6	698	6.5
Other	6,234	1.5	7,165	1.7	(931)	(13.0)
Residential:						
Real estate	70,273	17.3	68,160	16.4	2,113	3.1
Construction	3,081	0.8	6,145	1.5	(3,064)	(49.9)
Total	406,331	100.0	415,801	100.0	(9,470)	(2.3)
Allowance for loan losses	8,144		7,898		246	
Loans, net	\$398,187		\$407,903		\$(9,716)	

Allowance for loan losses

Management continually evaluates the credit quality of the Company's loan portfolio and performs a formal review of the adequacy of the allowance for loan losses (the allowance) on a quarterly basis. The allowance reflects management's best estimate of the amount of credit losses in the loan portfolio. Management's judgment is based on the evaluation of individual loans, past experience, the assessment of current economic conditions and other relevant factors including the amounts and timing of cash flows expected to be received on impaired loans. Those estimates may be susceptible to significant change. The provision for loan losses represents the amount necessary to maintain an appropriate allowance. Loan losses are charged directly against the allowance when loans are deemed to be uncollectible. Recoveries from previously charged-off loans are added to the allowance when received.

Management applies two primary components during the loan review process to determine proper allowance levels. The two components are a specific loan loss allocation for loans that are deemed impaired and a general loan loss allocation for those loans not specifically allocated. The methodology to analyze the adequacy of the allowance for loan losses is as follows:

- identification of specific impaired loans by loan category;
- calculation of specific allowances where required for the impaired loans based on collateral and other objective and quantifiable evidence;
 - determination of homogenous pools by loan category and eliminating the impaired loans;
 - application of historical loss percentages (two-year average) to pools to determine the allowance allocation;
 - application of qualitative factor adjustment percentages to historical losses for trends or changes in the loan portfolio, and/or current economic conditions.

Allocation of the allowance for different categories of loans is based on the methodology as explained above. A key element of the methodology to determine the allowance is the Company's credit risk evaluation process, which includes credit risk grading of individual commercial loans. Commercial loans are assigned credit risk grades based on the Company's assessment of conditions that affect the borrower's ability to meet its contractual obligations under the loan agreement. That process includes reviewing borrowers' current financial information, historical payment experience, credit documentation, public information and other information specific to each individual borrower. Upon review, the commercial loan credit risk grade is revised or reaffirmed. The credit risk grades may be changed at any time management feels an upgrade or downgrade may be warranted. The credit risk grades for the commercial loan portfolio are taken into account in the reserve methodology and loss factors are applied based upon the credit risk grades. The loss factors applied are based upon the Company's historical experience as well as what management believes to be best practices and within common industry standards. Historical experience reveals there is a direct correlation between the credit risk grades and loan charge-offs. The changes in allocations in the commercial loan portfolio from period-to-period are based upon the credit risk grading system and from periodic reviews of the loan portfolio.

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Each quarter, management performs an assessment of the allowance and the provision for loan losses. The Company's Special Assets Committee meets quarterly and the applicable lenders discuss each relationship under review and reach a consensus on the appropriate estimated loss amount based on current accounting guidelines. The Special Assets Committee's focus is on ensuring the pertinent facts are considered and the reserve amounts pursuant to the accounting principles are reasonable. The assessment process includes the review of all loans on a non-accruing basis as well as a review of certain loans to which the lenders or the Company's Credit Administration function have assigned a criticized or classified risk rating.

Total charge-offs net of recoveries for the six months ending June 30, 2011, were \$604,000, compared to \$925,000 in the first six months of 2010. The reduced level of charge-offs recorded in the current year is primarily attributable to lower charge-offs incurred in the commercial portfolio. Recoveries of \$7,000 were recorded on commercial and industrial loans at June 30, 2011 compared to commercial and industrial loan net charge-offs of \$262,000 for the six months ending June 30, 2010. Consumer loan net charge-offs of \$356,000 were recorded during the six months ending June 30, 2011 versus \$146,000 at the June 30, 2010 like period end. There were \$163,000 of commercial real estate loan net charge-offs during the six month period ending June 30, 2011 versus \$454,000 of net charge-offs at June 30, 2010. Residential real estate loan net charge-offs totaled \$91,000 for the six month period ending June 30, 2011. There were \$63,000 of residential real estate charge-offs in the same period of 2010. For a discussion on the provision for loan losses, see the "Provision for loan losses," located in the results of operations section of management's discussion and analysis contained herein.

The allowance for loan losses was \$8,144,000 at June 30, 2011 and \$7,898,000 at December 31, 2010. Management believes that the current balance in the allowance for loan losses of \$8,144,000 is sufficient to withstand the identified potential credit quality issues that may arise and others unidentified but inherent in the portfolio as of this time. Potential problem loans are those where there is known information that leads management to believe repayment of principal and/or interest is in jeopardy and the loans are currently neither on non-accrual status nor past due 90 days or more. Given continuing pressure on property values and the generally uncertain economic backdrop, there could be additional instances which become identified in future periods that may require additional charge-offs and/or increases to the allowance. The ratio of allowance for loan losses to total loans was 2.00% at June 30, 2011 compared to 1.90% at December 31, 2010.

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The following tables set forth the activity in the allowance for loan losses and certain key ratios for the period indicated:

	As of and for the six months ended June 30, 2011	As of and for the twelve months ended December 31, 2010	As of and for the six months ended June 30, 2010
Balance at beginning of period	\$ 7,897,822	\$ 7,573,603	\$ 7,573,603
Provision charged to operations	850,000	2,085,000	875,000
Charge-offs:			
Commercial and industrial	-	451,979	265,154
Commercial real estate	193,319	892,426	455,755
Consumer	369,933	462,816	169,776
Residential	98,835	1,812	63,214
Total	662,087	1,809,033	953,899
Recoveries:			
Commercial and industrial	6,556	3,839	2,949
Commercial real estate	30,281	2,799	1,449
Consumer	13,593	39,904	24,148
Residential	7,479	1,710	-
Total	57,909	48,252	28,546
Net charge-offs	604,178	1,760,781	925,353
Balance at end of period	\$ 8,143,644	\$ 7,897,822	\$ 7,523,250
Total loans, end of period	\$ 406,816,473	\$ 416,014,151	\$ 428,122,754

	As of and for the six months ended June 30, 2011		As of and for the twelve months ended December 31, 2010		As of and for the six months ended June 30, 2010	
Net charge-offs to (annualized):						
Average loans	0.29	%	0.41	%	0.43	%
Allowance for loan losses	14.84	%	22.29	%	24.60	%
Provision for loan losses	0.71	x	0.84	x	1.06	x
Allowance for loan losses to:						
Total loans	2.00	%	1.90	%	1.76	%
Non-accrual loans	0.85	x	0.79	x	0.84	x
Non-performing loans	0.80	x	0.77	x	0.81	x
Net charge-offs (annualized)	6.74	x	4.48	x	4.07	x
Loans 30-89 days past due and still accruing	\$ 3,903,063		\$ 2,611,162		\$ 3,295,675	
Loans 90 days past due and accruing	\$ 579,363		\$ 288,618		\$ 319,828	
Non-accrual loans	\$ 9,590,847		\$ 9,968,675		\$ 8,918,932	
	14.06	x	27.36	x	23.52	x

Explanation of Responses:

Allowance for loan losses to loans 90 days or more past
due and accruing

Non-performing assets

The Company defines non-performing assets as accruing loans past due 90 days or more, non-accrual loans, restructured loans, other real estate owned (ORE), non-accrual securities and repossessed assets. As of June 30, 2011, non-performing assets represented 2.37% of total assets basically unchanged from 2.38% at December 31, 2010.

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In the review of loans for both delinquency and collateral sufficiency, management concluded that there were a number of loans that lacked the ability to repay in accordance with contractual terms. The decision to place loans on a non-accrual status is made on an individual basis after considering factors pertaining to each specific loan. The commercial loans are placed on non-accrual status when management has determined that payment of all contractual principal and interest is in doubt or the loan is past due 90 days or more as to principal and interest, unless well-secured and in the process of collection. Consumer loans secured by real estate are placed on non-accrual status at 120 days past due as to principal and interest, and unsecured consumer loans are charged-off when the loan is 90 days or more past due as to principal and interest. Uncollected interest income accrued on all non-accrual loans is reversed and charged to interest income.

The non-performing assets for the period were comprised of non-accruing commercial loans, non-accruing real estate loans, troubled debt restructurings, non-accrual securities and ORE. Most of the loans are collateralized, thereby mitigating the Company's potential for loss. At June 30, 2011, \$881,000 of corporate bonds consisting of pooled trust preferred securities were on non-accrual status, compared to \$1,706,000 at June 30, 2010. For a further discussion on the Company's securities portfolio, see Note 3, "Investments securities", within the notes to the consolidated financial statements and the section entitled "Investments", contained within this management discussion and analysis section.

Non-performing loans declined slightly from \$10,257,000 on December 31, 2010 to \$10,170,000 at June 30, 2011. At December 31, 2010, the over 90 day past due portion was comprised of eight loans ranging from \$1,600 to \$111,000, and the non-accrual loan portion numbered 65 loans ranging from \$2,900 to \$1,800,000. At June 30, 2011, there were nine loans ranging from \$1,000 to \$317,000 in the over 90 days past due category, and 68 loans ranging from \$2,800 to \$1,500,000 in the non-accrual category.

The Company, on a regular basis, reviews changes to loans to determine if they meet the definition of a troubled debt restructuring (TDR). TDR loans arise when a borrower experiences financial difficulty and the Company grants a concession that it would not otherwise grant based on current underwriting standards in order to maximize the Company's recovery. TDR loans aggregated \$3,544,000 at June 30, 2011 which consisted of \$2,068,000 of accruing commercial real estate loans and \$1,476,000 of non-accrual commercial real estate loans. A non-accruing TDR in the amount of \$1,476,000 is included in the non-accrual loan totals. During the quarter, the borrower failed to comply with the revised terms of the agreement and remedies are being pursued. At December 31, 2010 TDRs aggregated \$783,000 all of which were accruing loans. The TDR amount increased by \$2,761,000 during the period ending June 30, 2011. One loan relationship aggregating \$1,752,000 which had been on non-accrual was restructured and subsequently reduced to \$1,476,000. It will remain on non-accrual status until specific performance has been demonstrated. A second, unrelated loan in the amount of \$1,784,000 was restructured and classified as a TDR due to concessions granted, however, this loan had been and continues to be paid current and remains on an accruing status. A third loan of approximately \$500,000 which had been a TDR at December 31, 2010 was subsequently removed based upon performance.

If applicable, a TDR loan classified as non-accrual would require a minimum of six months of payments before consideration for a return to accrual status. Concessions made to borrowers typically involve an extension of the loan's maturity date or a change in the loan's amortization period. The Company believes concessions have been made in the best interests of the borrower and the Company. The Company has not reduced interest rates, forgiven principal or entered into any forbearance or other actions with respect to these loans. If loans characterized as a TDR perform according to the restructured terms for a satisfactory period of time, the TDR designation may be removed in a new calendar year if the loan yields a market rate of interest.

ORE at June 30, 2011 was \$847,000 and consisted of three properties. At June 30, 2011, the non-accrual loans aggregated \$9,591,000 as compared to \$9,969,000 at December 31, 2010. The net reduction in the level of non-accrual loans during the period ending June 30, 2011 occurred as follows: additions to the non-accrual loan

component of the non-performing assets totaling \$2,661,000 were made during the first six months of the year. These were offset by reductions or payoffs of \$1,518,000, charge-offs of \$581,000, and \$940,000 of loans that returned to performing status. Loans past due 90 days or more and accruing were \$579,000 at June 30, 2011 and \$289,000, at December 31, 2010. Non-accrual securities amounted to \$881,000 at June 30, 2011 and \$1,091,000 at December 31, 2010. The ratio of non-performing loans to total loans was 2.50% at June 30, 2011 and 2.47% at December 31, 2010.

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The following table sets forth non-performing assets data as of the period indicated:

	June 30, 2011	December 31, 2010	June 30, 2010
Loans past due 90 days or more and accruing	\$579,363	\$ 288,618	\$319,828
Non-accrual loans	9,590,847	9,968,675	8,918,931
Total non-performing loans	10,170,210	10,257,293	9,238,759
Troubled debt restructurings	2,067,595	782,688	791,168
Other real estate owned	847,360	1,260,895	1,084,007
Non-accrual securities	880,787	1,091,311	1,705,937
Total non-performing assets	\$13,965,952	\$ 13,392,187	\$12,819,871
Total loans including HFS	\$406,816,473	\$ 416,014,151	\$428,122,754
Total assets	\$588,683,907	\$ 561,673,152	\$579,270,283
Non-accrual loans to total loans	2.36	% 2.40	% 2.08
Non-performing loans to total loans	2.50	% 2.47	% 2.16
Non-performing assets to total assets	2.37	% 2.38	% 2.21

The composition of non-performing loans as of June 30, 2011 is as follows (dollars in thousands):

	Gross loan balances	Past due 90 days or more and still accruing	Non-accrual loans	Total non-performing loans	% of gross loans
Commercial and industrial	\$83,445	\$ -	\$437	\$437	0.52 %
Commercial real estate:					
Non-owner occupied	80,981	11	1,616	1,627	2.01
Owner occupied	68,994	-	2,655	2,655	3.85
Construction	13,337	-	566	566	4.24
Consumer:					
Home equity installment	38,034	-	756	756	1.99
Home equity line of credit	30,520	-	358	358	1.17
Auto	11,432	18	-	18	0.16
Other	6,234	2	45	47	0.76
Residential:					
Real estate	70,273	317	3,064	3,381	4.81
Construction	3,081	231	94	325	10.56
Loans held-for-sale	485	-	-	-	-
Total	\$406,816	\$ 579	\$9,591	\$10,170	2.50 %

Foreclosed assets held-for-sale

Foreclosed assets held-for-sale, consisting of ORE, was \$847,000 at June 30, 2011 and consisted of three properties which are listed for sale with local realtors. The \$414,000 decline in ORE from the December 31, 2010 balance of \$1,261,000 is mainly the result of the sale of two residential properties.

Deposits

The Bank is a community-based commercial financial institution, member FDIC, which offers a variety of deposit products with varying ranges of interest rates and terms. Deposit products include savings, clubs, interest-bearing checking (NOW), money market, non-interest-bearing checking (DDAs) and certificates of deposit accounts. Certificates of deposit accounts, or CDs, are deposits with stated maturities which can range from seven days to ten years. The flow of deposits is significantly influenced by general economic conditions, changes in prevailing interest rates, pricing and competition. To determine deposit product offering interest rates, the Company considers local competition, spreads to earning-asset yields, liquidity position and rates charged for alternative sources of funding such as borrowings and FHLB advances. Like all banks, the Company competes for deposits. When setting interest rates, the deposit-gathering strategies also include consideration of the Company's balance sheet structure and cost effectiveness that are mindful of the current and forecasted economic climate.

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Compared to December 31, 2010 total deposits grew \$24,480,000, or 5%, during the six months ended June 30, 2011. The growth in total deposits was due to increases in DDA, savings and money market accounts of \$12,970,000, or 15%, \$8,837,000, or 8% and \$19,020,000, or 24%, respectively, partially offset by lower CDs and NOW balances. Generally, deposits are obtained from consumers and businesses within the communities that surround the Company's 11 branch offices and all deposits are insured by the FDIC up to the full extent permitted by law. The increase in DDA accounts was primarily due to the Company's relationship with various municipalities and has historically benefited from inflow of their seasonal tax deposits. As the municipal deposits are seasonal in nature, their balances are highly volatile and very often, unpredictable. Growth in DDA balances was further embellished due to success in strengthening relationships with business customers. The increase in savings and money markets was caused by the transfer of maturing CDs, creative campaigning and customer sentiment for immediately available deposits. In an effort to grow and retain core deposits, the Company introduces innovative options to its variety of deposit products. The Company has successfully focused on providing exemplary customer service and introducing highly innovative deposit-gathering techniques. This approach has strengthened the Company's low-cost funding base. The continued low interest rate environment has resulted in a wide-spread preference for customers to place their money in non-maturing interest-bearing accounts rather than renew maturing CDs. When the market rates do rise, the Company will focus on and promote CD gathering strategies that will strive to increase time deposits while maintaining its low-costing core deposit foundation.

The following table represents the components of deposits as of the date indicated (dollars in thousands):

	June 30, 2011		December 31, 2010	
	Amount	%	Amount	%
Money market	\$98,630	19.4	\$79,610	16.5
NOW	67,268	13.3	67,572	14.0
Savings and club	114,672	22.6	105,835	21.9
Certificates of deposit	127,606	25.2	143,651	29.8
Total interest-bearing	408,176	80.5	396,668	82.2
Non-interest-bearing	98,751	19.5	85,780	17.8
Total deposits	\$506,927	100.0	\$482,448	100.0

The Company uses the Certificate of Deposit Account Registry Service (CDARS) reciprocal program to obtain FDIC insurance protection for customers who have large deposits that at times may exceed the FDIC maximum amount of \$250,000. In the CDARS program, deposits with varying terms and interest rates, originated in the Company's own markets, are exchanged for deposits of other financial institutions that are members in the CDARS network. By placing these deposits in other participating institutions, the deposits of our customers are fully insured by the FDIC. In return for deposits placed with network institutions, the Company receives from network institutions deposits that are approximately equal in amount and contain similar terms as those placed for our customers. Deposits the Company receives, or reciprocal deposits, from other institutions are considered brokered deposits by regulatory definitions. As of June 30, 2011, CDARS represented \$10,841,000, or 2%, of total deposits, compared to \$11,876,000, or 2%, of total deposits at December 31, 2010. Excluding CDARS, certificates of deposit accounts of \$100,000 or more amounted to \$41,087,000 and \$51,340,000 at June 30, 2011 and December 31, 2010, respectively. Certificates of deposit of \$250,000 or more amounted to \$11,853,000 and \$19,120,000 as of June 30, 2011 and December 31, 2010.

Including CDARS, approximately 28% and 39% of the CDs are scheduled to mature in 2011 and 2012, respectively. Renewing CDs may re-price to lower or higher market rates depending on the direction of interest rate movements, the shape of the yield curve, competition, the rate profile of the maturing accounts and depositor preference for alternative products. In this current low interest rate environment, a widespread preference has been for customers with maturing CDs to hold their deposits in readily available transaction products such as savings or money

market accounts. When interest rates begin to rise, the Company expects CDs to grow to more normal levels.

Borrowings

Borrowings are used as a complement to deposit generation as an alternative funding source whereby the Bank will borrow under customer repurchase agreements in the local market, advances from the Federal Home Loan Bank of Pittsburgh (FHLB) and other correspondent banks for asset growth and liquidity needs.

Repurchase agreements are non-insured interest-bearing liabilities that have a perfected security interest in qualified investments of the Company. The FDIC Depositor Protection Act of 2009 requires banks to provide a perfected security interest to the purchasers of uninsured repurchase agreements. Repurchase agreements are offered through a sweep product. A sweep account is designed to ensure that on a daily basis, an attached DDA is adequately funded and excess funds are transferred, or swept, into an interest-bearing overnight repurchase agreement account. Due to the constant inflow and outflow of funds of the sweep product, their balances tend to be somewhat volatile, similar to a DDA. Customer liquidity is the typical cause for variances in repurchase agreements, which for the first six months of 2011 decreased \$164,000, or 2%, from December 31, 2010.

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The components of borrowings as of June 30, 2011 and December 31, 2010 are as follows (dollars in thousands):

	June 30, 2011		December 31, 2010	
	Amount	%	Amount	%
Repurchase agreements	\$ 7,384	25.5	\$ 7,548	25.5
Demand note, U.S. Treasury	623	2.1	1,000	3.4
FHLB advances:				
Long-term	21,000	72.4	21,000	71.1
Total borrowings	\$ 29,007	100.0	\$ 29,548	100.0

Item 3. Quantitative and Qualitative Disclosure About Market Risk

Management of interest rate risk and market risk analysis.

In January 2010, the Federal Financial Institutions Examination Council (FFIEC) released an Advisory on Interest Rate Risk Management (IRR Advisory) to remind institutions of the supervisory expectations regarding sound practices for managing interest rate risk. While some degree of interest rate risk is inherent in the business of banking, the FFIEC expects financial institutions to have sound risk management practices in place to measure monitor and control interest rate risk exposures, and interest rate risk management should be an integral component of an institution's risk management infrastructure. The FFIEC expects all institutions to manage their interest rate risk exposures using processes and systems commensurate with the balance sheet complexity, business model, risk profile, scope of operations, earnings and capital levels. The IRR Advisory reiterates the importance of effective corporate governance, policies and procedures, risk measuring and monitoring systems, stress testing, and internal controls related to the interest rate risk exposures of institutions.

The IRR Advisory encourages institutions to use a variety of techniques to measure interest rate risk exposure including: gap analysis, income measurement and valuation measurement for assessing the impact of changes in market rates and simulation modeling to measure interest rate risk exposure. The IRR Advisory also reminds institutions that stress testing, which includes both scenario and sensitivity analysis, is an integral component of interest rate risk management. Institutions should regularly assess interest rate risk exposures beyond typical industry conventions and towards the given economic climate including changes in rates of a magnitude that is greater than the general practice of up and down 200 basis points and different scenarios to reflect changes in slopes of the yield curve.

The adequacy and effectiveness of an institution's interest rate risk management process and the level of its exposures are critical factors in the regulatory evaluation of an institution's sensitivity to changes in interest rates and capital adequacy. Management believes the Company's interest rate risk measurement framework is sound and provides an effective means to measure, monitor, analyze, indentify and control interest rate risk in the balance sheet.

The Company is subject to the interest rate risks inherent in its lending, investing and financing activities. Fluctuations of interest rates will impact interest income and interest expense along with affecting market values of all interest-earning assets and interest-bearing liabilities, except for those assets or liabilities with a short term remaining to maturity. Interest rate risk management is an integral part of the asset/liability management process. The Company has instituted certain procedures and policy guidelines to manage the interest rate risk position. Those internal policies enable the Company to react to changes in market rates to protect net interest income from significant fluctuations. The primary objective in managing interest rate risk is to minimize the adverse impact of changes in interest rates on net interest income along with creating an asset/liability structure that maximizes earnings.

Asset/Liability Management. One major objective of the Company when managing the rate sensitivity of its assets and liabilities is to stabilize net interest income. The management of and authority to assume interest rate risk is the responsibility of the Company's Asset/Liability Committee (ALCO), which is comprised of senior management and members of the board of directors. ALCO meets quarterly to monitor the relationship of interest-sensitive assets to interest-sensitive liabilities. The process to review interest rate risk is a regular part of managing the Company. Consistent policies and practices of measuring and reporting interest rate risk exposure, particularly regarding the treatment of non-contractual assets and liabilities, are in effect. In addition, there is an annual process to review the interest rate risk policy with the board of directors which includes limits on the impact to earnings from shifts in interest rates.

Interest Rate Risk Measurement. Interest rate risk is monitored through the use of three complementary measures: static gap analysis, earnings at risk simulation and economic value at risk simulation. While each of the interest rate risk measurements has limitations, taken together they represent a reasonably comprehensive view of the magnitude of interest rate risk in the Company and the distribution of risk along the yield curve, the level of risk through time and the amount of exposure to changes in certain interest rate relationships.

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Static Gap. The ratio between assets and liabilities re-pricing in specific time intervals is referred to as an interest rate sensitivity gap. Interest rate sensitivity gaps can be managed to take advantage of the slope of the yield curve as well as forecasted changes in the level of interest rate changes.

To manage this interest rate sensitivity gap position, an asset/liability model commonly known as cumulative gap analysis is used to monitor the difference in the volume of the Company's interest-sensitive assets and liabilities that mature or re-price within given time intervals. A positive gap (asset sensitive) indicates that more assets will mature or re-price during a given period compared to liabilities, while a negative gap (liability sensitive) has the opposite effect. The Company employs computerized net interest income simulation modeling to assist in quantifying interest rate risk exposure. This process measures and quantifies the impact on net interest income through varying interest rate changes and balance sheet compositions. The use of this model assists the ALCO to gauge the effects of the interest rate changes on interest-sensitive assets and liabilities in order to determine what impact these rate changes will have upon the net interest spread. As of June 30, 2011, the Bank maintained a one-year cumulative gap of positive \$51.1 million, or 8.7%, of total assets. The effect of this positive gap position provided a mismatch of assets and liabilities which may expose the Bank to interest rate risk during periods of falling interest rates. Conversely, in an increasing interest rate environment, net interest income could be positively impacted because more assets than liabilities would re-price upward during the one-year period.

Certain shortcomings are inherent in the method of analysis discussed above and presented in the next table. Although certain assets and liabilities may have similar maturities or periods of re-pricing, they may react in different degrees to changes in market interest rates. The interest rates on certain types of assets and liabilities may fluctuate in advance of changes in market interest rates, while interest rates on other types of assets and liabilities may lag behind changes in market interest rates. Certain assets, such as adjustable-rate mortgages, have features which restrict changes in interest rates on a short-term basis and over the life of the asset. In the event of a change in interest rates, prepayment and early withdrawal levels may deviate significantly from those assumed in calculating the table. The ability of many borrowers to service their adjustable-rate debt may decrease in the event of an interest rate increase.

The following table illustrates the Company's interest sensitivity gap position at June 30, 2011 (dollars in thousands):

	Three months or less	More than three months to twelve months	More than one year to three years	More than three years	Total
Cash and cash equivalents	\$ 25,662	\$ -	\$-	\$21,014	\$46,676
Investment securities (1)(2)	3,141	19,697	24,703	51,264	98,805
Loans (2)	135,926	65,649	111,784	85,314	398,673
Fixed and other assets	-	9,581	-	34,949	44,530
Total assets	\$ 164,729	\$ 94,927	\$136,487	\$192,541	\$588,684
Total cumulative assets	\$ 164,729	\$ 259,656	\$396,143	\$588,684	
Non-interest bearing transaction deposits (3)	\$ -	\$ 9,876	\$27,157	\$61,718	\$98,751
Interest-bearing transaction deposits (3)	106,151	13,315	110,024	51,080	280,570
Time deposits	16,902	54,321	42,414	13,969	127,606
Repurchase agreements	7,384	-	-	-	7,384
Short-term borrowings	623	-	-	-	623
Long-term debt	-	-	5,000	16,000	21,000
Other liabilities	-	-	-	2,404	2,404
Total liabilities	\$ 131,060	\$ 77,512	\$184,595	\$145,171	\$538,338

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Total cumulative liabilities	\$ 131,060	\$ 208,572	\$393,167	\$538,338
Interest sensitivity gap	\$ 33,669	\$ 17,415	\$(48,108)	\$47,370
Cumulative gap	\$ 33,669	\$ 51,084	\$2,976	\$50,346
Cumulative gap to total assets	5.7	% 8.7	% 0.5	% 8.6

(1) Includes FHLB stock and the net unrealized gains/losses on securities AFS.

(2) Investments and loans are included in the earlier of the period in which interest rates were next scheduled to adjust or the period in which they are due. In addition, loans are included in the periods in which they are scheduled to be repaid based on scheduled amortization. For amortizing loans and MBS – GSE residential, annual prepayment rates are assumed reflecting historical experience as well as management’s knowledge and experience of its loan products.

(3) The Bank’s demand and savings accounts are generally subject to immediate withdrawal. However, management considers a certain amount of such accounts to be core accounts having significantly longer effective maturities based on the retention experiences of such deposits in changing interest rate environments. The effective maturities presented are the recommended maturity distribution limits for non-maturing deposits based on historical deposit studies.

Earnings at Risk and Economic Value at Risk Simulations. The Company recognizes that more sophisticated tools exist for measuring the interest rate risk in the balance sheet that extend beyond static re-pricing gap analysis. Although it will continue to measure its re-pricing gap position, the Company utilizes additional modeling for identifying and measuring the interest rate risk in the overall balance sheet. The ALCO is responsible for focusing on “earnings at risk” and “economic value at risk”, and how both relate to the risk-based capital position when analyzing the interest rate risk.

Earnings at Risk. Earnings at risk simulation measures the change in net interest income and net income should interest rates rise and fall. The simulation recognizes that not all assets and liabilities re-price one-for-one with market rates (e.g., savings rate). The ALCO looks at “earnings at risk” to determine income changes from a base case scenario under an increase and decrease of 200 basis points in interest rate simulation models.

Economic Value at Risk. Earnings at risk simulation measures the short-term risk in the balance sheet. Economic value (or portfolio equity) at risk measures the long-term risk by finding the net present value of the future cash flows from the Company’s existing assets and liabilities. The ALCO examines this ratio quarterly utilizing an increase and decrease of 200 basis points in interest rate simulation models. The ALCO recognizes that, in some instances, this ratio may contradict the “earnings at risk” ratio.

The following table illustrates the simulated impact of 200 basis points upward or downward movement in interest rates on net interest income, net income and the change in the economic value (portfolio equity). This analysis assumes that interest-earning asset and interest-bearing liability levels at June 30, 2011 remain constant. The impact of the rate movements was developed by simulating the effect of rates changing over a twelve-month period from the June 30, 2011 levels:

	Rates +200		Rates -200	
Earnings at risk:				
Percent change in:				
Net interest income	2.6	%	(1.4))%
Net income	8.4		(4.8))
Economic value at risk:				
Percent change in:				
Economic value of equity	(22.8)	(1.5)
Economic value of equity as a percent of book assets	(1.8)	(0.1))

Economic value has the most meaning when viewed within the context of risk-based capital. Therefore, the economic value may normally change beyond the Company's policy guideline for a short period of time as long as the risk-based capital ratio (after adjusting for the excess equity exposure) is greater than 10%. As of June 30, 2011, the Company’s risk-based capital ratio was 12.4%.

The table below summarizes estimated changes in net interest income over a twelve-month period beginning July 1, 2011, under alternate interest rate scenarios using the income simulation model described above (dollars in thousands):

Change in interest rates	Net interest income	\$ variance	% variance
+200 basis points	\$ 21,684	\$ 548	2.6 %
+100 basis points	21,235	99	0.5

Explanation of Responses:

Flat rate	21,136	-	-
-100 basis points	21,242	106	0.5
-200 basis points	20,835	(301)	(1.4)

Simulation models require assumptions about certain categories of assets and liabilities. The models schedule existing assets and liabilities by their contractual maturity, estimated likely call date or earliest re-pricing opportunity. MBS – GSE residential securities and amortizing loans are scheduled based on their anticipated cash flow including estimated prepayments. For investment securities, the Bank uses a third-party service to provide cash flow estimates in the various rate environments. Savings, money market and NOW accounts do not have a stated maturity or re-pricing term and can be withdrawn or re-priced at any time. This may impact the interest margin if more expensive alternative sources of deposits are required to fund loans or deposit runoff. Management projects the re-pricing characteristics of these accounts based on historical performance and assumptions that it believes reflect their rate sensitivity. The model reinvests all maturities, repayments and prepayments for each type of asset or liability into the same product for a new like term at current product interest rates. As a result, the mix of interest-earning assets and interest bearing-liabilities is held constant.

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Liquidity

Liquidity management ensures that adequate funds will be available to meet customers' needs for borrowings, deposit withdrawals and maturities and normal operating expenses of the Company. Current sources of liquidity are cash and cash equivalents, asset maturities and pay-downs within one year, loans HFS, investments AFS, growth of core deposits, growth of repurchase agreements, increases of other borrowed funds from correspondent banks and issuance of capital stock. Although regularly scheduled investment and loan payments are a dependable source of daily funds, sales of loans HFS, investments AFS, deposit activity and investment and loan prepayments are significantly influenced by general economic conditions and the interest rate environment. During low and declining interest rate environments, prepayments from interest-sensitive assets tend to accelerate and provide significant liquidity which can be used to invest in other interest-earning assets but at lower market rates. Conversely, during periods of high and rising interest rates, prepayments from interest-sensitive assets tend to decelerate causing cash flow from mortgage loans and the MBS-GSE residential securities portfolio to decrease. Rising interest rates may also cause deposit inflow to accelerate at higher market interest rates. The Company closely monitors activity in the capital markets and takes appropriate action to ensure that the liquidity levels are adequate for funding, investing and operating activities.

The Company utilizes a contingency funding plan (CFP) that sets a framework for handling liquidity issues in the event circumstances arise which the Company deems to be less than normal. To accomplish this, the Company established guidelines for identifying, measuring, monitoring and managing the resolution of potentially serious liquidity crises. The Company's CFP outlines required monitoring tools, acceptable alternative funding sources and required actions during various liquidity scenarios. Thus, the Company has implemented a proactive means for the measurement and resolution for dealing with potentially significant adverse liquidity issues. At least quarterly, the CFP monitoring tools, current liquidity position and monthly projected liquidity sources and uses are presented and reviewed by the Company's ALCO. As of June 30, 2011, the Company has not experienced any adverse liquidity issues that would give rise to its inability to raise liquidity in an emergency situation.

For the six months ended June 30, 2011, the Company generated \$23.7 million of cash. The Company's operations provided \$7.8 million mostly from the \$10.4 million of net cash inflow from the components of net interest income partially offset by net-noninterest expense and also from the \$3.1 million of net proceeds from mortgage banking services. The \$24.3 million of net growth in deposits and repurchase agreements as well as cash inflow from investment calls and maturities and loan pay downs helped fund new security purchases, and net dividend payments. The excess cash will be used to prudently grow interest-earning assets, facility upgrades and provide for the unpredictable, seasonal and sporadic deposit cash flow from the Company's municipal customers.

The Company is a party to financial instruments with off-balance sheet risk in the normal course of business in order to meet the financing needs of its customers and in connection with the overall interest rate management strategy. These instruments involve, to a varying degree, elements of credit, interest rate and liquidity risk. In accordance with GAAP, these instruments are not recorded in the consolidated financial statements. Such instruments primarily include lending commitments. Lending commitments include commitments to originate loans and commitments to fund unused lines of credit. Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established by contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since some of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements.

In addition to lending commitments, the Company has contractual obligations related to operating lease commitments, certificates of deposit, FHLB advances and repurchase agreements. Operating lease commitments are obligations under various non-cancelable operating leases on buildings and land used for office space and other bank purposes. The Company's position with respect to lending commitments and significant contractual obligations, both

on a short- and long-term basis has not changed materially from December 31, 2010.

As of June 30, 2011, the Company maintained \$46.7 million in cash and cash equivalents, \$98.8 million in securities AFS and loans HFS and had approximately \$173.3 million available to borrow from the FHLB, the Discount Window of the Federal Reserve Bank, correspondent banks and CDARS. The combined total of \$318.8 represented 54% of total assets as of June 30, 2011. Management believes this level of liquidity to be strong and adequate to support current operations.

Capital

During the six months ended June 30, 2011, total shareholders' equity increased \$3,572,000, or 8%. The improvement was caused by: net income of \$2,515,000; a \$1,461,000 (net of a \$35,000 non-credit-related OTTI) after tax improvement in the market value of the AFS securities portfolio; \$67,000 in proceeds from employees enrolled in the Company's Employee Stock Purchase Plan; partially offset by \$495,000 of dividends paid to shareholders, net of dividends reinvested and optional cash payments received from participants in the Company's Dividend Reinvestment Plan.

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As of June 30, 2011, the Company reported a net unrealized loss of \$2,356,000, net of tax, from the securities AFS, an improvement compared to the net unrealized loss of \$3,817,000 as of December 31, 2010. The condition of the economy continues to assert uncertainty in the financial and capital markets and has had a sizable and prolonged negative impact on the fair value estimates on the securities in banks' investment portfolios, including the Company's investment portfolio. Management of the Company maintains these changes are due principally to liquidity problems in the financial markets and to a lesser extent to the deterioration in the creditworthiness of the issuers.

The Company (on a consolidated basis) and the Bank are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possible additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company's and the Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and the Bank must meet specific capital guidelines that involve quantitative measures of their assets, liabilities and certain off-balance-sheet items as calculated under regulatory accounting practices. The capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk-weightings and other factors. Prompt corrective action provisions are not applicable to bank holding companies.

Under these guidelines, assets and certain off-balance sheet items are assigned to broad risk categories, each with appropriate weights. The resulting capital ratios represent capital as a percentage of total risk-weighted assets and certain off-balance sheet items. The appropriate risk-weighting, pursuant to regulatory guidelines, requires a gross-up in the risk-weighting of securities that were rated below investment grade, thereby significantly inflating the total risk-weighted assets. This requirement had an adverse impact on the total capital and Tier I capital ratios in 2011 and 2010. The regulatory guidelines require all banks and bank holding companies to maintain a minimum ratio of total risk-based capital to total risk-weighted assets (Total Risk Adjusted Capital) of 8%, including Tier I capital to total risk-weighted assets (Tier I Capital) of 4% and Tier I capital to average total assets (Leverage Ratio) of at least 4%. As of June 30, 2011, the Company and the Bank met all capital adequacy requirements to which it was subject.

The Company continues to closely monitor and evaluate alternatives to enhance its capital ratios as the regulatory and economic environments change. The following table depicts the capital amounts and ratios of the Company and the Bank as of June 30, 2011:

	Actual amount	Ratio		For capital adequacy purposes Amount	Ratio		To be well capitalized under prompt corrective action provisions Amount	Ratio
Total capital								
(to risk-weighted assets)								
Consolidated	\$ 56,024,453	12.4	% ≥	\$ 36,203,793	≥	8.0	%	N/A
Bank	\$ 55,825,698	12.3	% ≥	\$ 36,189,249	≥	8.0	% ≥	\$ 45,236,561 ≥ 10.0 %
Tier I capital								
(to risk-weighted assets)								
Consolidated	\$ 50,268,234	11.1	% ≥	\$ 18,101,896	≥	4.0	%	N/A
Bank	\$ 50,139,263	11.1	% ≥	\$ 18,094,624	≥	4.0	% ≥	\$ 27,141,936 ≥ 6.0 %
Tier I capital								
(to average assets)								
Consolidated	\$ 50,268,234	8.5	% ≥	\$ 23,691,286	≥	4.0	%	N/A
Bank	\$ 50,139,263	8.5	% ≥	\$ 23,674,409	≥	4.0	% ≥	\$ 29,593,011 ≥ 5.0 %

Item 4T. Controls and Procedures

As of the end of the period covered by this Quarterly Report on Form 10-Q, an evaluation was carried out by the Company's management, with the participation of its President and Chief Executive Officer and Chief Financial Officer, of the effectiveness of the Company's disclosure controls and procedures, as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934. Based on such evaluation, the President and Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are designed to ensure that information required to be disclosed in the reports the Company files or furnishes under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and regulations, and are effective. The Company made no changes in its internal controls over financial reporting or in other factors that materially affected, or are reasonably likely to materially affect, these controls during the last fiscal quarter ended June 30, 2011.

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PART II - Other Information

Item 1. Legal Proceedings

The nature of the Company's business generates some litigation involving matters arising in the ordinary course of business. However, in the opinion of the Company after consultation with legal counsel, no legal proceedings are pending, which, if determined adversely to the Company or the Bank, would have a material effect on the Company's undivided profits or financial condition. No legal proceedings are pending other than ordinary routine litigation incidental to the business of the Company and the Bank. In addition, to management's knowledge, no governmental authorities have initiated or contemplated any material legal actions against the Company or the Bank.

Item 1A. Risk Factors

The following are additional risk factors that should be read in conjunctions with Item 1A, "Risk Factors" that were disclosed in the Company's December 31, 2010 Form 10-K filed with the Securities and Exchange Commission on March 29, 2011.

The Downgrade of the United States Government may adversely affect the Company.

In July 2011, certain rating agencies placed the United States government's long-term sovereign debt rating on their equivalent of negative watch and announced the possibility of a rating downgrade. The rating agencies, due to constraints related to the rating of the United States, also placed government-sponsored enterprises in which the Company invests and receives lines of credit on negative watch and a downgrade of the United State's credit rating would trigger a similar downgrade in the credit rating of these government sponsored enterprises. Furthermore, the credit rating of other entities, such as state and local governments, may also be downgraded should the United States credit rating be downgraded. In August 2011, one rating agency downgraded the U.S. government's debt rating from AAA to AA+. The impact that this credit rating downgrade may have on the national and local economy could have an adverse effect on the Company's financial condition and results of operations.

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

None

Item 3. Default Upon Senior Securities

None

Item 4. (Removed and Reserved)

None

Item 5. Other Information

None

Item 6. Exhibits

The following exhibits are filed herewith or incorporated by reference as a part of this Form 10-Q:

Explanation of Responses:

3(i) Amended and Restated Articles of Incorporation of Registrant. Incorporated by reference to Annex B of the Proxy Statement/Prospectus included in Registrant's Amendment 4 to its Registration Statement No. 333-90273 on Form S-4, filed with the SEC on April 6, 2000.

3(ii) Amended and Restated Bylaws of Registrant. Incorporated by reference to Exhibit 3(ii) to Registrant's Form 8-K filed with the SEC on November 21, 2007.

*10.1 1998 Independent Directors Stock Option Plan of The Fidelity Deposit and Discount Bank, as assumed by Registrant. Incorporated by reference to Exhibit 10.1 to Registrant's Registration Statement No. 333-90273 on Form S-4, filed with the SEC on November 3, 1999.

*10.2 1998 Stock Incentive Plan of The Fidelity Deposit and Discount Bank, as assumed by Registrant. Incorporated by reference to Exhibit 10.2 of Registrant's Registration Statement No. 333-90273 on Form S-4, filed with the SEC on November 3, 1999.

*10.3 Registrant's 2000 Dividend Reinvestment Plan. Incorporated by reference to Exhibit 4 to Registrant's Registration Statement No. 333-45668 on Form S-1, filed with the SEC on September 12, 2000 and as amended by Pre-Effective Amendment No. 1 on October 11, 2000, by Post-Effective Amendment No. 1 on May 30, 2001, by Post-Effective Amendment No. 2 on July 7, 2005, by Registration Statement No. 333-152806 on Form S-3 filed on August 6, 2008 and by Post-Effective Amendment No. 1 on January 25, 2010.

*10.4 Registrant's 2000 Independent Directors Stock Option Plan. Incorporated by reference to Exhibit 4.3 to Registrant's Registration Statement No. 333-64356 on Form S-8 filed with the SEC on July 2, 2001.

*10.5 Amendment, dated October 2, 2007, to the Registrant's 2000 Independent Directors Stock Option Plan. Incorporated by reference to Exhibit 10.2 to Registrant's Form 8-K filed with the SEC on October 4, 2007.

*10.6 Registrant's 2000 Stock Incentive Plan. Incorporated by reference to Exhibit 4.4 to Registrant's Registration Statement No. 333-64356 on Form S-8 filed with the SEC on July 2, 2001.

*10.7 Amendment, dated October 2, 2007, to the Registrant's 2000 Stock Incentive Plan. Incorporated by reference to Exhibit 10.1 to Registrant's Form 8-K filed with the SEC on October 4, 2007.

*10.8 Registrant's 2002 Employee Stock Purchase Plan. Incorporated by reference to Exhibit 4.4 to Registrant's Registration Statement No. 333-113339 on Form S-8 filed with the SEC on March 5, 2004.

*10.9 Change of Control Agreement with Salvatore R. DeFrancesco, Registrant and The Fidelity Deposit and Discount Bank, dated March 21, 2006. Incorporated by reference to Exhibit 99.2 to Registrant's Current Report on Form 8-K filed with the SEC on March 27, 2006.

*10.10 Amended and Restated Executive Employment Agreement between Fidelity D & D Bancorp, Inc., The Fidelity Deposit and Discount Bank and Daniel J. Santaniello, dated March 23, 2011. Incorporated by reference to Exhibit 99.1 to Registrant's Current Report on Form 8-K filed with the SEC on March 29, 2011.

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*10.12 Change in Control and Severance Agreement between Fidelity D & D Bancorp, Inc., The Fidelity Deposit and Discount Bank and John T. Piszak, dated March 23, 2011. Incorporated by reference to Exhibit 99.3 to Registrant's Current Report on Form 8-K filed with the SEC on March 29, 2011.

11 Statement regarding computation of earnings per share. Included herein in Note No. 5, "Earnings per share," contained within the Notes to Consolidated Financial Statements, and incorporated herein by reference.

31.1 Rule 13a-14(a) Certification of Principal Executive Officer, filed herewith.

31.2 Rule 13a-14(a) Certification of Principal Financial Officer, filed herewith.

32.1 Certification of Principal Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, filed herewith.

32.2 Certification of Principal Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, filed herewith.

101 Interactive data files: The following, from Fidelity D&D Bancorp, Inc.'s Quarterly Report on Form 10-Q for the quarter ended June 30, 2011, is formatted in XBRL (eXtensible Business Reporting Language: Consolidated Balance Sheets at June 30, 2011 and December 31, 2010; Consolidated Statements of Income for the three and six months ended June 30, 2011 and June 30, 2010; Consolidated Statements of Changes in Shareholders' Equity for the six months ended June 30, 2011 and June 30, 2010 and Consolidated Statements of Cash Flows for the six months ended June 30, 2011 and June 30, 2010.

* Management contract or compensatory plan or arrangement.

Signatures

FIDELITY D & D BANCORP, INC.

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.

Fidelity D & D Bancorp, Inc.

Date: August 12, 2011

/s/ Daniel J. Santaniello
Daniel J. Santaniello,
President and Chief Executive Officer

Fidelity D & D Bancorp, Inc.

Date: August 12, 2011

/s/ Salvatore R. DeFrancesco, Jr.
Salvatore R. DeFrancesco, Jr.,
Treasurer and Chief Financial Officer

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* Incorporated by Reference

** Pursuant to Rule 406T of Regulation S-T, the interactive data files in Exhibit 101 hereto are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, are deemed not filed for purposes of Section 18 of the Securities and Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.

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