FIRST UNITED CORP/MD/
Form 10-K
March 15, 2013

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-K

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

For the fiscal year ended December 31, 2012

Commission file number 0-14237

FIRST UNITED CORPORATION

(Exact name of registrant as specified in its charter)

Maryland	**52-1380770**
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification Number)*
19 South Second Street, Oakland, Maryland	**21550-0009**
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number, including area code: **(800) 470-4356**

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class:	Name of Each Exchange on Which Registered:
Common Stock, par value $.01 per share	**NASDAQ Global Select Market**

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

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

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

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

Indicate by check mark if disclosures of delinquent filers pursuant to Item 405 of Regulation S-K (Section 229.405 of this chapter) is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.¨

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

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

The aggregate market value of the registrant's outstanding voting and non-voting common equity held by non-affiliates as of June 30, 2012: **$23,749,764.**

The number of shares of the registrant's common stock outstanding as of February 28, 2013: **6,199,283**

Documents Incorporated by Reference

Portions of the registrant's definitive proxy statement for the 2013 Annual Meeting of Shareholders to be filed with the SEC pursuant to Regulation 14A are incorporated by reference into Part III of this Annual Report on Form 10-K.

First United Corporation

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Forward-Looking Statements

This Annual Report on Form 10-K of First United Corporation ("we", "our" or "us" on a consolidated basis) contains forward-looking statements within the meaning of The Private Securities Litigation Reform Act of 1995. Such statements include projections, predictions, expectations or statements as to beliefs or future events or results or refer to other matters that are not historical facts. Forward-looking statements are subject to known and unknown risks, uncertainties and other factors that could cause the actual results to differ materially from those contemplated by the statements. The forward-looking statements contained in this annual report are based on various factors and were derived using numerous assumptions. In some cases, you can identify these forward-looking statements by words like "may", "will", "should", "expect", "plan", "anticipate", "intend", "believe", "estimate", "predict", "potential", or "continue" or those words and other comparable words. You should be aware that those statements reflect only our predictions. If known or unknown risks or uncertainties should materialize, or if underlying assumptions should prove inaccurate, actual results could differ materially from past results and those anticipated, estimated or projected. You should bear this in mind when reading this annual report and not place undue reliance on these forward-looking statements. Factors that might cause such differences include, but are not limited to:

- the risk that the weak national and local economies and depressed real estate and credit markets caused by the recent global recession will continue to decrease the demand for loan, deposit and other financial services and/or increase loan delinquencies and defaults;
- changes in market rates and prices may adversely impact the value of securities, loans, deposits and other financial instruments and the interest rate sensitivity of our balance sheet;
- our liquidity requirements could be adversely affected by changes in our assets and liabilities;
- the effect of legislative or regulatory developments, including changes in laws concerning taxes, banking, securities, insurance and other aspects of the financial services industry;
- competitive factors among financial services organizations, including product and pricing pressures and our ability to attract, develop and retain qualified banking professionals;
- the effect of changes in accounting policies and practices, as may be adopted by the Financial Accounting Standards Board, the Securities and Exchange Commission (the "SEC"), the Public Company Accounting Oversight Board and other regulatory agencies; and
- the effect of fiscal and governmental policies of the United States federal government.

You should also consider carefully the risk factors discussed in Item 1A of Part I of this annual report, which address additional factors that could cause our actual results to differ from those set forth in the forward-looking statements and could materially and adversely affect our business, operating results and financial condition. The risks discussed in this annual report are factors that, individually or in the aggregate, management believes could cause our actual results to differ materially from expected and historical results. You should understand that it is not possible to predict or identify all such factors. Consequently, you should not consider such disclosures to be a complete discussion of all potential risks or uncertainties.

The forward-looking statements speak only as of the date on which they are made, and, except to the extent required by federal securities laws, we undertake no obligation to update any forward-looking statement to reflect events or circumstances after the date on which the statement is made or to reflect the occurrence of unanticipated events. In addition, we cannot assess the impact of each factor on our business or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statements.

ITEM 1. BUSINESS

General

First United Corporation is a Maryland corporation chartered in 1985 and a financial holding company registered under the federal Bank Holding Company Act of 1956, as amended. First United Corporation's primary business is serving as the parent company of First United Bank & Trust, a Maryland trust company (the "Bank"), First United Statutory Trust I ("Trust I") and First United Statutory Trust II ("Trust II"), both Connecticut statutory business trusts, and First United Statutory Trust III, a Delaware statutory business trust ("Trust III" and together with Trust I and Trust II, the "Trusts"). The Trusts were formed for the purpose of selling trust preferred securities that qualified as Tier 1 capital. First United Corporation is also the parent company of First United Insurance Group, LLC, a Maryland limited liability company (the "Insurance Agency") that, through the close of business on December 31, 2011, operated as a full service insurance agency. Effective on January 1, 2012, the Insurance Agency sold substantially all of its assets, net of cash, to a third-party and is no longer an active subsidiary. The Bank has three wholly-owned subsidiaries: OakFirst Loan Center, Inc., a West Virginia finance company; OakFirst Loan Center, LLC, a Maryland finance company (collectively, the "OakFirst Loan Centers"), and First OREO Trust, a Maryland statutory trust formed for the purposes of servicing and disposing of the real estate that the Bank acquires through foreclosure or by deed in lieu of foreclosure. The Bank owns a majority interest in Cumberland Liquidation Trust, a Maryland statutory trust formed for the purposes of servicing and disposing of real estate that secured a loan made by another bank and in which the Bank held a participation interest. The Bank also owns 99.9% of the limited partnership interests in Liberty Mews Limited Partnership, a Maryland limited partnership formed for the purpose of acquiring, developing and operating low-income housing units in Garrett County, Maryland.

At December 31, 2012, we had total assets of approximately $1.32 billion, net loans of approximately $858.8 million, and deposits of approximately $ 976.9 million. Shareholders' equity at December 31, 2012 was approximately $98.9 million.

First United Corporation maintains an Internet website at www.mybank4.com on which it makes available, free of charge, its Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, and all amendments to the foregoing as soon as reasonably practicable after these reports are electronically filed with, or furnished to, the SEC.

Banking Products and Services

The Bank operates 27 banking offices, one call center and 29 Automated Teller Machines ("ATMs") in Allegany County, Frederick County, Garrett County, and Washington County in Maryland, and in Berkeley County, Mineral County, Hardy County, and Monongalia County in West Virginia. The Bank is an independent community bank providing a complete range of retail and commercial banking services to businesses and individuals in its market areas. Services offered are essentially the same as those offered by the regional institutions that compete with the Bank and include checking, savings, money market deposit accounts, and certificates of deposit, business loans, personal loans, mortgage loans, lines of credit, and consumer-oriented retirement accounts including individual retirement accounts (“IRAs”) and employee benefit accounts. In addition, the Bank provides full brokerage services through a networking arrangement with Cetera Investment Services, LLC., a full service broker-dealer. The Bank also provides safe deposit and night depository facilities, and insurance products and trust services. The Bank’s deposits are insured by the Federal Deposit Insurance Corporation (the “FDIC”).

Lending Activities— Our lending activities are conducted through the Bank. Since 2010, the Bank has not been originating any new loans through the OakFirst Loan Centers and their sole activity is servicing existing loans.

The Bank’s commercial loans are primarily secured by real estate, commercial equipment, vehicles or other assets of the borrower. Repayment is often dependent on the successful business operations of the borrower and may be affected by adverse conditions in the local economy or real estate market. The financial condition and cash flow of commercial borrowers is therefore carefully analyzed during the loan approval process, and continues to be monitored throughout the duration of the loan by obtaining business financial statements, personal financial statements and income tax returns. The frequency of this ongoing analysis depends upon the size and complexity of the credit and collateral that secures the loan. It is also the Bank’s general policy to obtain personal guarantees from the principals of the commercial loan borrowers.

Commercial real estate (“CRE”) loans are primarily those secured by land for residential and commercial development, agricultural purpose properties, service industry buildings such as restaurants and motels, retail buildings and general purpose business space. The Bank attempts to mitigate the risks associated with these loans through low loan to value ratio standards, thorough financial analyses, and management’s knowledge of the local economy in which the Bank lends.

The risk of loss associated with CRE construction lending is controlled through conservative underwriting procedures such as loan to value ratios of 80% or less, obtaining additional collateral when prudent, analysis of cash flows, and closely monitoring construction projects to control disbursement of funds on loans.

The Bank's residential mortgage portfolio is distributed between variable and fixed rate loans. Many loans are booked at fixed rates in order to meet the Bank's requirements under the Community Reinvestment Act or to complement our asset liability mix. Other fixed rate residential mortgage loans are originated in a brokering capacity on behalf of other financial institutions, for which the Bank receives a fee. As with any consumer loan, repayment is dependent on the borrower's continuing financial stability, which can be adversely impacted by job loss, divorce, illness, or personal bankruptcy. Residential mortgage loans exceeding an internal loan-to-value ratio require private mortgage insurance. Title insurance protecting the Bank's lien priority, as well as fire and casualty insurance, is also required.

Home equity lines of credit, included within the residential mortgage portfolio, are secured by the borrower's home and can be drawn on at the discretion of the borrower. These lines of credit are at variable interest rates.

The Bank also provides residential real estate construction loans to builders and individuals for single family dwellings. Residential construction loans are usually granted based upon "as completed" appraisals and are secured by the property under construction. Site inspections are performed to determine pre-specified stages of completion before loan proceeds are disbursed. These loans typically have maturities of six to 12 months and may have a fixed or variable rate. Permanent financing for individuals offered by the Bank includes fixed and variable rate loans with three or five year adjustable rate mortgages.

A variety of other consumer loans are also offered to customers, including indirect and direct auto loans, and other secured and unsecured lines of credit and term loans. Careful analysis of an applicant's creditworthiness is performed before granting credit, and on-going monitoring of loans outstanding is performed in an effort to minimize risk of loss by identifying problem loans early.

An allowance for loan losses is maintained to provide for anticipated losses from our lending activities. A complete discussion of the factors considered in determination of the allowance for loan losses is included in Item 7 of Part II of this report.

Deposit Activities— The Bank offers a full array of deposit products including checking, savings and money market accounts, regular and IRA certificates of deposit, Christmas Savings accounts, College Savings accounts, and Health Savings accounts. The Bank also offers the Certificate of Deposit Account Registry Service®, or CDARS®, program to municipalities, businesses, and consumers through which the Bank provides access to multi-million-dollar certificates of deposit that are FDIC-insured. Since the termination of the Transaction Account Guarantee ("TAG") program as of December 31, 2012, the Bank offers Insured Cash Sweep, or ICS, program to municipalities, businesses, and consumers through which the Bank provides access to multi-million-dollar savings and demand deposits that are FDIC-insured. In addition, we offer our commercial customers packages which include Treasury Management, Cash Sweep and various checking opportunities.

Information about our income from and assets related to our banking business may be found in the Consolidated Statements of Financial Condition and the Consolidated Statements of Income and the related notes thereto included in Item 8 of Part II of this annual report.

Trust Services—The Bank’s Trust Department offers a full range of trust services, including personal trust, investment agency accounts, charitable trusts, retirement accounts including IRA roll-overs, 401(k) accounts and defined benefit plans, estate administration and estate planning.

At December 31, 2012 and 2011, the total market value of assets under the supervision of the Bank’s Trust Department was approximately $637 million and $595 million, respectively. Trust Department revenues for these years may be found in the Consolidated Statements of Income under the heading “Other operating income”, which is contained in Item 8 of Part II of this annual report.

Insurance Activities—Through December 31, 2011, we offered a full range of insurance products and services to customers in our market areas through the Insurance Agency. Information about income from insurance activities for each of the years ended December 31, 2011 and 2010 may be found under “Other Operating Income” in the Consolidated Statements of Income included in Item 8 of Part II of this annual report. The Insurance Agency sold substantially all of its assets, net of cash, effective on January 1, 2012.

COMPETITION

The banking business, in all of its phases, is highly competitive. Within our market areas, we compete with commercial banks, (including local banks and branches or affiliates of other larger banks), savings and loan associations and credit unions for loans and deposits, with consumer finance companies for loans, and with other financial institutions for various types of products and services. There is also competition for commercial and retail banking business from banks and financial institutions located outside our market areas and on the internet.

The primary factors in competing for deposits are interest rates, personalized services, the quality and range of financial services, convenience of office locations and office hours. The primary factors in competing for loans are interest rates, loan origination fees, the quality and range of lending services and personalized services.

To compete with other financial services providers, we rely principally upon local promotional activities, personal relationships established by officers, directors and employees with its customers, and specialized services tailored to meet its customers' needs. In those instances in which we are unable to accommodate a customer's needs, we attempt to arrange for those services to be provided by other financial services providers with which we have a relationship.

The following table sets forth deposit data for the Maryland and West Virginia Counties in which the Bank maintains offices as of June 30, 2012, the most recent date for which comparative information is available.

	Offices (in Market)	Deposits (in thousands)	Market Share	
Allegany County, Maryland:				
Susquehanna Bank	5	$ 296,051	44.21	%
Manufacturers & Traders Trust Company	6	162,292	24.23	%
First United Bank & Trust	4	116,823	17.44	%
PNC Bank NA	3	50,131	7.48	%
Standard Bank	2	44,493	6.64	%

Source: FDIC Deposit Market Share Report

Frederick County, Maryland:				
PNC Bank NA	20	1,053,620	27.11	%
Branch Banking & Trust Co.	12	711,851	18.32	%
Bank Of America NA	6	313,184	8.06	%
Frederick County Bank	5	266,996	6.87	%
Manufacturers & Traders Trust Company	6	248,306	6.39	%
Capital One NA	6	205,053	5.28	%
Woodsboro Bank	7	197,956	5.10	%
BlueRidge Bank	2	150,954	3.89	%
First United Bank & Trust	4	144,687	3.72	%
Wells Fargo Bank NA	2	142,092	3.66	%
SunTrust Bank	3	131,566	3.39	%
Middletown Valley Bank	4	125,195	3.22	%
Sandy Spring Bank	4	91,989	2.37	%
Sovereign Bank	1	44,202	1.14	%
Columbia Bank	2	24,724	0.64	%
SONABANK	1	18,345	0.47	%
Damascus Community Bank	1	13,997	0.36	%
Woodforest National Bank	1	310	0.01	%

Source: FDIC Deposit Market Share Report

Garrett County, Maryland:				
First United Bank & Trust	6	350,052	60.36	%
Susquehanna Bank	2	101,043	17.42	%
Manufacturers & Traders Trust Company	5	92,607	15.97	%
Clear Mountain Bank	1	29,837	5.14	%
Miners & Merchants Bank	1	6,409	1.11	%

Source: FDIC Deposit Market Share Report

Washington County, Maryland:				
Susquehanna Bank	12	641,259	32.46	%
Columbia Bank	11	410,851	20.79	%
Manufacturers & Traders Trust Company	11	376,039	19.03	%
PNC Bank NA	5	167,257	8.47	%
United Bank	2	105,183	5.32	%

First United Bank & Trust	3	79,185	4.01	%
Sovereign Bank	3	75,844	3.84	%
Capital One NA	2	41,139	2.08	%
Citizens National Bank of Berkeley Springs	1	38,206	1.93	%
Orrstown Bank	1	26,088	1.32	%
Jefferson Security Bank	1	7,833	0.40	%
Middletown Valley Bank	1	6,898	0.35	%

Source: FDIC Deposit Market Share Report

Berkeley County, West Virginia:				
Branch Banking & Trust Company	5	324,690	28.61	%
United Bank	5	205,502	18.10	%
First United Bank & Trust	5	130,704	11.52	%
City National Bank of West Virginia	4	120,611	10.63	%
Susquehanna Bank	3	117,859	10.38	%
Jefferson Security Bank	2	69,756	6.15	%
MVB Bank Inc.	1	62,430	5.50	%
Bank of Charles Town	2	48,052	4.23	%
Citizens National Bank of Berkeley Springs	3	41,335	3.64	%
Summit Community Bank	1	13,412	1.18	%
Woodforest National Bank	1	724	0.06	%

Source: FDIC Deposit Market Share Report

Hardy County, West Virginia:				
Summit Community Bank, Inc.	4	463,283	73.59	%
Capon Valley Bank	3	112,422	17.86	%
Pendleton Community Bank, Inc.	1	25,851	4.11	%
First United Bank & Trust	1	16,164	2.57	%
Grant County Bank	1	11,787	1.87	%

Source: FDIC Deposit Market Share Report

Mineral County, West Virginia:				
First United Bank & Trust	2	75,822	35.21	%
Branch Banking & Trust Company	2	68,803	31.95	%
Manufacturers & Traders Trust Company	2	40,687	18.90	%
Grant County Bank	1	30,005	13.94	%

Source: FDIC Deposit Market Share Report

Monongalia County, West Virginia:				
United Bank	7	657,372	32.36	%
Branch Banking & Trust Company	6	549,438	27.04	%
Huntington National Bank	6	378,620	18.64	%
Clear Mountain Bank	5	171,150	8.42	%
Wesbanco Bank, Inc.	5	104,931	5.16	%
First United Bank & Trust	3	89,599	4.41	%
First Exchange Bank	1	28,643	1.41	%
Citizens Bank of Morgantown, Inc.	1	21,716	1.07	%

MVB Bank, Inc.	1	18,062	0.89	%
PNC Bank NA	2	12,208	0.60	%

Source: FDIC Deposit Market Share Report

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For further information about competition in our market areas, see the Risk Factor entitled "**We operate in a competitive environment, and our inability to effectively compete could adversely and materially impact our financial condition and results of operations**" in Item 1A of Part I of this annual report.

SUPERVISION AND REGULATION

The following is a summary of the material regulations and policies applicable to First United Corporation and its subsidiaries and is not intended to be a comprehensive discussion. Changes in applicable laws and regulations may have a material effect on our business.

General

First United Corporation is a financial holding company registered with the Board of Governors of the Federal Reserve System (the "FRB") under the BHC Act and, as such, is subject to the supervision, examination and reporting requirements of the BHC Act and the regulations of the FRB. As a publicly-traded company whose common stock is listed on The NASDAQ Global Select Market, First United Corporation is also subject to regulation and supervision by the SEC and The NASDAQ Stock Market, LLC ("NASDAQ").

The Bank is a Maryland trust company subject to the banking laws of Maryland and to regulation by the Commissioner of Financial Regulation of Maryland (the "Maryland Commissioner"), who is required by statute to make at least one examination in each calendar year (or at 18-month intervals if the Maryland Commissioner determines that an examination is unnecessary in a particular calendar year). The Bank also has offices in West Virginia, and the operations of these offices are subject to West Virginia laws and to supervision and examination by the West Virginia Division of Banking. As a member of the FDIC, the Bank is also subject to certain provisions of federal law and regulations regarding deposit insurance and activities of insured state-chartered banks, including those that require examination by the FDIC. In addition to the foregoing, there are a myriad of other federal and state laws and regulations that affect, impact or govern the business of banking, including consumer lending, deposit-taking, and trust operations.

All non-bank subsidiaries of First United Corporation are subject to examination by the FRB, and, as affiliates of the Bank, are subject to examination by the FDIC and the Maryland Commissioner. In addition, OakFirst Loan Center, Inc. is subject to licensing and regulation by the West Virginia Division of Banking, OakFirst Loan Center, LLC is subject to licensing and regulation by the Maryland Commissioner, and the Insurance Group was subject to licensing and regulation by various state insurance authorities. Retail sales of insurance products by these insurance affiliates are also subject to the requirements of the Interagency Statement on Retail Sales of Nondeposit Investment Products promulgated in 1994 by the FDIC, the FRB, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision.

Regulation of Financial Holding Companies

In November 1999, the federal Gramm-Leach-Bliley Act (the “GLB Act”) was signed into law. The GLB Act revised the BHC Act and repealed the affiliation provisions of the Glass-Steagall Act of 1933, which, taken together, limited the securities, insurance and other non-banking activities of any company that controls a FDIC insured financial institution. Under the GLB Act, a bank holding company can elect, subject to certain qualifications, to become a “financial holding company.” The GLB Act provides that a financial holding company may engage in a full range of financial activities, including insurance and securities sales and underwriting activities, and real estate development, with new expedited notice procedures. Maryland law generally permits state-chartered banks, including the Bank, to engage in the same activities, directly or through an affiliate, as national banking associations. The GLB Act permits certain qualified national banking associations to form financial subsidiaries, which have broad authority to engage in all financial activities except insurance underwriting, insurance investments, real estate investment or development, or merchant banking. Thus, the GLB Act has the effect of broadening the permitted activities of First United Corporation and the Bank.

First United Corporation and its affiliates are subject to the provisions of Section 23A and Section 23B of the Federal Reserve Act. Section 23A limits the amount of loans or extensions of credit to, and investments in, First United Corporation and its non-bank affiliates by the Bank. Section 23B requires that transactions between the Bank and First United Corporation and its non-bank affiliates be on terms and under circumstances that are substantially the same as with non-affiliates.

Under FRB policy, First United Corporation is expected to act as a source of strength to the Bank, and the FRB may charge First United Corporation with engaging in unsafe and unsound practices for failure to commit resources to a subsidiary bank when required. This support may be required at times when the bank holding company may not have the resources to provide the support. Under the prompt corrective action provisions, if a controlled bank is undercapitalized, then the regulators could require the bank holding company to guarantee the bank’s capital restoration plan. In addition, if the FRB believes that a bank holding company’s activities, assets or affiliates represent a significant risk to the financial safety, soundness or stability of a controlled bank, then the FRB could require the bank holding company to terminate the activities, liquidate the assets or divest the affiliates. The regulators may require these and other actions in support of controlled banks even if such actions are not in the best interests of the bank holding company or its stockholders. Because the Corporation is a bank holding company, it is viewed as a source of financial and managerial strength for any controlled depository institutions, like the Bank.

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), which made sweeping changes to the financial regulatory landscape and will impact all financial institutions, including First United Corporation and the Bank. The Dodd-Frank Act also directs federal bank regulators to require that all companies that directly or indirectly control an insured depository institution serve as sources of financial strength for the institution. The term "source of financial strength" is defined under the Dodd-Frank Act as the ability of a company to provide financial assistance to its insured depository institution subsidiaries in the event of financial distress. The appropriate federal banking agency for such a depository institution may require reports from companies that control the insured depository institution to assess their abilities to serve as sources of strength and to enforce compliance with the source-of-strength requirements. The appropriate federal banking agency may also require a holding company to provide financial assistance to a bank with impaired capital. Under this requirement, in the future First United Corporation could be required to provide financial assistance to the Bank should it experience financial distress.

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In addition, under the Financial Institutions Reform, Recovery and Enforcement Act of 1989 ("FIRREA"), depository institutions insured by the FDIC can be held liable for any losses incurred by, or reasonably anticipated to be incurred by, the FDIC in connection with (i) the default of a commonly controlled FDIC-insured depository institution or (ii) any assistance provided by the FDIC to a commonly controlled FDIC-insured depository institution in danger of default. Accordingly, in the event that any insured subsidiary of First United Corporation causes a loss to the FDIC, other insured subsidiaries of First United Corporation could be required to compensate the FDIC by reimbursing it for the estimated amount of such loss. Such cross guaranty liabilities generally are superior in priority to obligations of a financial institution to its shareholders and obligations to other affiliates.

Federal Banking Regulation

Federal banking regulators, such as the FRB and the FDIC, may prohibit the institutions over which they have supervisory authority from engaging in activities or investments that the agencies believe are unsafe or unsound banking practices. Federal banking regulators have extensive enforcement authority over the institutions they regulate to prohibit or correct activities that violate law, regulation or a regulatory agreement or which are deemed to be unsafe or unsound practices. Enforcement actions may include the appointment of a conservator or receiver, the issuance of a cease and desist order, the termination of deposit insurance, the imposition of civil money penalties on the institution, its directors, officers, employees and institution-affiliated parties, the issuance of directives to increase capital, the issuance of formal and informal agreements, the removal of or restrictions on directors, officers, employees and institution-affiliated parties, and the enforcement of any such mechanisms through restraining orders or other court actions.

The Bank is subject to certain restrictions on extensions of credit to executive officers, directors, and principal shareholders or any related interest of such persons, which generally require that such credit extensions be made on substantially the same terms as those available to persons who are not related to the Bank and not involve more than the normal risk of repayment. Other laws tie the maximum amount that may be loaned to any one customer and its related interests to capital levels.

As part of the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA"), each federal banking regulator adopted non-capital safety and soundness standards for institutions under its authority. These standards include internal controls, information systems and internal audit systems, loan documentation, credit underwriting, interest rate exposure, asset growth, and compensation, fees and benefits. An institution that fails to meet those standards may be required by the agency to develop a plan acceptable to meet the standards. Failure to submit or implement such a plan may subject the institution to regulatory sanctions. We believe that the Bank meets substantially all standards that have been adopted. FDICIA also imposes capital standards on insured depository institutions.

The Dodd-Frank Act made sweeping changes to the financial regulatory landscape and will impact all financial institutions, including First United Corporation and the Bank. The Dodd-Frank Act is discussed below.

The Community Reinvestment Act ("CRA") requires the FDIC, in connection with its examination of financial institutions within its jurisdiction, to evaluate the record of those financial institutions in meeting the credit needs of their communities, including low and moderate income neighborhoods, consistent with principles of safe and sound banking practices. These factors are also considered by all regulatory agencies in evaluating mergers, acquisitions and applications to open a branch or facility. As of the date of its most recent examination report, the Bank had a CRA rating of "Satisfactory".

The Bank is also subject to a variety of other laws and regulations with respect to the operation of its business, including, but not limited to, the Truth in Lending Act, the Truth in Savings Act, the Equal Credit Opportunity Act, the Electronic Funds Transfer Act, the Fair Housing Act, the Home Mortgage Disclosure Act, the Fair Debt Collection Practices Act, the Fair Credit Reporting Act, Expedited Funds Availability (Regulation CC), Reserve Requirements (Regulation D), Privacy of Consumer Information (Regulation P), Margin Stock Loans (Regulation U), the Right To Financial Privacy Act, the Flood Disaster Protection Act, the Homeowners Protection Act, the Servicemembers Civil Relief Act, the Real Estate Settlement Procedures Act, the Telephone Consumer Protection Act, the CAN-SPAM Act, the Children's Online Privacy Protection Act, and the John Warner National Defense Authorization Act.

The Dodd-Frank Act

The Dodd-Frank Act, enacted in July 2010, significantly changed the bank regulatory structure and affected the lending, investment, trading and operating activities of financial institutions and their holding companies. The Dodd-Frank Act requires the FRB to set minimum capital levels for bank holding companies that are as stringent as those required for insured depository institutions. The legislation also establishes a floor for capital of insured depository institutions that cannot be lower than the standards in effect today, and directs the federal banking regulators to implement new leverage and capital requirements. The new leverage and capital requirements must take into account off-balance sheet activities and other risks, including risks relating to securitized products and derivatives. Pursuant to the Dodd-Frank Act, the FDIC has backup enforcement authority over a depository institution holding company, such as First United Corporation, if the conduct or threatened conduct of such holding company poses a risk to the Deposit Insurance Fund ("DIF"), although such authority may not be used if the holding company is generally in sound condition and does not pose a foreseeable and material risk to the DIF. In addition, the Dodd-Frank Act contains a wide variety of provisions (many of which are not yet effective) affecting the regulation of depository institutions, including restrictions related to mortgage originations, risk retention requirements as to securitized loans and the establishment of the Consumer Financial Protection Bureau ("CFPB").

The full impact of the Dodd-Frank Act on our business and operations will not be known for years until regulations implementing the statute are written and adopted. The Dodd-Frank Act will increase our regulatory compliance burden and costs and may restrict the financial products and services we offer to our customers. In particular, the Dodd-Frank Act will require us to invest significant management attention and resources so that we can evaluate the impact of this law and its regulations and make any necessary changes to our product offerings and operations. These impacts may be material.

Capital Requirements

General

FDICIA established a system of prompt corrective action to resolve the problems of undercapitalized institutions. Under this system, the federal banking regulators are required to rate supervised institutions on the basis of five capital categories: "well capitalized," "adequately capitalized," "undercapitalized," "significantly undercapitalized," and "critically undercapitalized;" and to take certain mandatory actions (and are authorized to take other discretionary actions) with respect to institutions in the three undercapitalized categories. The severity of the actions will depend upon the category in which the institution is placed. A depository institution is "well capitalized" if it has a total risk based capital ratio of 10% or greater, a Tier 1 risk based capital ratio of 6% or greater, and a leverage ratio of 5% or greater and is not subject to any order, regulatory agreement, or written directive to meet and maintain a specific capital level for any capital measure. An "adequately capitalized" institution is defined as one that has a total risk based capital ratio of 8% or greater, a Tier 1 risk based capital ratio of 4% or greater and a leverage ratio of 4% or greater (or 3% or greater in the case of a bank with a composite CAMEL rating of 1).

FDICIA generally prohibits a depository institution from making any capital distribution, including the payment of cash dividends, or paying a management fee to its holding company if the depository institution would thereafter be undercapitalized. Undercapitalized depository institutions are subject to growth limitations and are required to submit capital restoration plans. For a capital restoration plan to be acceptable, the depository institution's parent holding company must guarantee (subject to certain limitations) that the institution will comply with such capital restoration plan.

Significantly undercapitalized depository institutions may be subject to a number of other requirements and restrictions, including orders to sell sufficient voting stock to become adequately capitalized and requirements to reduce total assets and stop accepting deposits from correspondent banks. Critically undercapitalized depository institutions are subject to the appointment of a receiver or conservator; generally within 90 days of the date such institution is determined to be critically undercapitalized.

Further information about our capital resources is provided in Item 7 of Part II of this annual report under the heading "Capital Resources". Information about the capital ratios of First United Corporation and of the Bank as of December 31, 2012 is set forth in Note 4 to our audited consolidated financial statements, which are included in Item 8 of Part II of this annual report (the "Consolidated Financial Statements"

The Collins Amendment provisions of the Dodd-Frank Act

The Collins Amendment provision of the Dodd-Frank Act imposes increased capital requirements in the future. The Collins Amendment also requires federal banking regulators to establish minimum leverage and risk-based capital requirements to apply to insured depository institutions, bank and thrift holding companies, and systemically important nonbank financial companies. These capital requirements must not be less than the Generally Applicable Risk Based Capital Requirements and the Generally Applicable Leverage Capital Requirements as of July 21, 2010, and must not be quantitatively lower than the requirements that were in effect for insured depository institutions as of July 21, 2010. The Collins Amendment defines Generally Applicable Risk Based Capital Requirements and Generally Applicable Leverage Capital Requirements to mean the risk-based capital requirements and minimum ratios of Tier 1 risk-based capital to average total assets, respectively, established by the appropriate federal banking agencies to apply to insured depository institutions under the Prompt Corrective Action provisions, regardless of total consolidated asset size or foreign financial exposure. Over a three-year phase-out period, trust preferred securities will no longer qualify as Tier 1 risk-based capital for certain bank holding companies, including First United Corporation. At December 31, 2012, $40.2 million in proceeds received from First United Corporation’s junior subordinated debentures offerings were included in Tier 1 risk-based capital.. The Collins Amendment stipulates that this phase out period begins in 2013. The Company continues to monitor the finalization of these requirements, including whether its junior subordinated debentures will continue to qualify for Tier 1 capital under the final rules.

Basel III — Capital, Liquidity and Stress Testing Requirements

The Basel Committee on Banking Supervision (“Basel”) has drafted frameworks for the regulation of capital and liquidity of internationally active banking organizations, generally referred to as “Basel III”. On June 7, 2012, the FRB issued a notice of proposed rulemaking that would implement elements of Sections 165 and 166 of the Dodd-Frank Act that encompass certain aspects of Basel III with respect to capital and liquidity. On November 9, 2012, following a public comment period, the U.S. federal banking agencies issued a joint press release announcing that the January 1, 2013 effective date was being delayed so the agencies could consider operational and transitional issues identified in the large volume of public comments received. It is anticipated that the U.S. federal banking agencies will formalize the implementation of the Basel III framework applicable to domestic banks in the United States during 2013. As proposed, the new rules, when implemented and fully phased-in, will require U.S. bank holding companies to maintain higher levels of capital and liquidity than the minimums that currently apply under existing capital regulations.

Capital Requirements

The Basel III final capital framework, among other things, (i) formalizes a capital measure called “Tier 1 Common Equity” (“T1CE”), (ii) specifies that Tier 1 capital consist only of T1CE and certain “Additional Tier 1 capital” instruments meeting specified requirements, and (iii) defines T1CE narrowly by requiring that most adjustments to regulatory capital measures be made to T1CE and not to the other components of capital. Requirements to maintain higher levels of capital could adversely impact our return on equity. We are in the process of modeling our capital ratios under various scenarios in light of these proposed rules and intend to take appropriate steps to ensure that we meet the fully-phased in minimum capital requirements, including capital conservation buffers, if and when these proposal rules are finalized.

Liquidity Requirements

Historically, regulation and monitoring of bank and bank holding company liquidity has been addressed as a supervisory matter, without required formulaic measures. The Basel III liquidity framework, however, requires banks and bank holding companies to measure their liquidity against specific liquidity tests that, although similar in some respects to liquidity measures historically applied by banks and regulators for management and supervisory purposes, going forward would be required by regulation. Current rules and proposals from the U.S. federal banking agencies do not specifically address the Basel III liquidity requirements.

See the section entitled “Capital Resources” in Item 7 of Part II of this annual report for further information.

Deposit Insurance

The Bank is a member of the FDIC and pays an insurance premium to the FDIC based upon its assessable deposits on a quarterly basis. Deposits are insured up to applicable limits by the FDIC and such insurance is backed by the full faith and credit of the United States Government.

Under the Dodd-Frank Act, a permanent increase in deposit insurance was authorized to $250,000. The coverage limit is per depositor, per insured depository institution for each account ownership category.

The Dodd-Frank Act also set a new minimum DIF reserve ratio at 1.35% of estimated insured deposits. The FDIC is required to attain this ratio by September 30, 2020. The Dodd-Frank Act required the FDIC to redefine the deposit insurance assessment base for an insured depository institution. Prior to the Dodd-Frank Act, an institution's assessment base has historically been its domestic deposits, with some adjustments. As redefined pursuant to the Dodd-Frank Act, an institution's assessment base is now an amount equal to the institution's average consolidated total assets during the assessment period minus average tangible equity. Institutions with less $1.0 billion or more in assets at the end of a fiscal quarter, like the Bank, must report their average consolidated total assets on a daily basis and report their average tangible equity on an end-of-month balance basis.

The Federal Deposit Insurance Reform Act of 2005, which created the DIF, gave the FDIC greater latitude in setting the assessment rates for insured depository institutions which could be used to impose minimum assessments. On May 22, 2009, the FDIC imposed an emergency insurance assessment of five basis points in an effort to restore the DIF to an acceptable level. On November 12, 2009, the FDIC adopted a final rule requiring insured depository institutions to prepay their estimated quarterly risk-based deposit assessments for the fourth quarter of 2009, and for all of 2010, 2011, and 2012, on December 30, 2009, along with each institution's risk based deposit insurance assessment for the third quarter of 2009. It was also announced that the assessment rate will increase by 3 basis points effective January 1, 2011. The prepayment is accounted for as a prepaid expense and is amortized quarterly. The prepaid assessment qualifies for a zero risk weight under the risk-based capital requirements. The Bank expensed $2.0 million and $2.4 million in FDIC premiums for 2012 and 2011, respectively. In December 2009, the Bank prepaid approximately $11 million in FDIC premiums and the balance at December 31, 2012 was approximately $3.2 million. The FDIC has the flexibility to adopt actual rates that are higher or lower than the total base assessment rates adopted without notice and comment, if certain conditions are met.

DIF-insured institutions pay a Financing Corporation ("FICO") assessment in order to fund the interest on bonds issued in the 1980s in connection with the failures in the thrift industry. For the fourth quarter of 2012, the FICO assessment was equal to 0.660 basis points computed on assets as required by the Dodd-Frank Act. These assessments will continue until the bonds mature in 2019.

The FDIC is authorized to conduct examinations of and require reporting by FDIC-insured institutions. It is also authorized to terminate a depository bank's deposit insurance upon a finding by the FDIC that the bank's financial condition is unsafe or unsound or that the institution has engaged in unsafe or unsound practices or has violated any applicable rule, regulation, order or condition enacted or imposed by the bank's regulatory agency. The termination of deposit insurance for our national bank subsidiary would have a material adverse effect on our earnings, operations and financial condition.

Bank Secrecy Act/Anti-Money Laundering

The Bank Secrecy Act ("BSA"), which is intended to require financial institutions to develop policies, procedures, and practices to prevent and deter money laundering, mandates that every national bank have a written, board-approved program that is reasonably designed to assure and monitor compliance with the BSA.

The program must, at a minimum: (i) provide for a system of internal controls to assure ongoing compliance; (ii) provide for independent testing for compliance; (iii) designate an individual responsible for coordinating and monitoring day-to-day compliance; and (iv) provide training for appropriate personnel. In addition, state-chartered banks are required to adopt a customer identification program as part of its BSA compliance program. State-chartered banks are also required to file Suspicious Activity Reports when they detect certain known or suspected violations of federal law or suspicious transactions related to a money laundering activity or a violation of the BSA.

In addition to complying with the BSA, the Bank is subject to the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (the "USA Patriot Act"). The USA Patriot Act is designed to deny terrorists and criminals the ability to obtain access to the United States' financial system and has significant implications for depository institutions, brokers, dealers, and other businesses involved in the transfer of money. The Patriot Act mandates that financial service companies implement additional policies and procedures and take heightened measures designed to address any or all of the following matters: customer identification programs, money laundering, terrorist financing, identifying and reporting suspicious activities and currency transactions, currency crimes, and cooperation between financial institutions and law enforcement authorities.

Ability-to-Repay and Qualified Mortgage Rule

Pursuant to the Dodd Frank Act, the CFPB issued a final rule on January 10, 2013 (effective on January 10, 2014), amending Regulation Z, as implemented by the Truth in Lending Act, that requires mortgage lenders to make a reasonable and good faith determination based on verified and documented information that a consumer applying for a mortgage loan has a reasonable ability to repay the loan according to its terms. Mortgage lenders are required to determine consumers' ability to repay in one of two ways. The first alternative requires the mortgage lender to consider the following eight underwriting factors when making the credit decision: (i) current or reasonably expected income or assets; (ii) current employment status; (iii) the monthly payment on the covered transaction; (iv) the monthly payment on any simultaneous loan; (v) the monthly payment for mortgage-related obligations; (vi) current debt obligations, alimony, and child support; (vii) the monthly debt-to-income ratio or residual income; and (viii) credit history. Alternatively, the mortgage lender can originate "qualified mortgages," which are entitled to a presumption that the creditor making the loan satisfied the ability-to-repay requirements. In general, a "qualified mortgage" is a mortgage loan without negative amortization, interest-only payments, balloon payments, or terms exceeding 30 years. In addition, to be a qualified mortgage the points and fees paid by a consumer cannot exceed 3% of the total loan amount. Qualified mortgages that are "higher-priced" (e.g. subprime loans) garner a rebuttable presumption of compliance with the ability-to-repay rules, while qualified mortgages that are not "higher-priced" (e.g. prime loans) are given a safe harbor of compliance.

Volcker Rule

The Dodd-Frank Act prohibits insured depository institutions and their holding companies from engaging in proprietary trading except in limited circumstances, and prohibits them from owning equity interests in excess of three percent (3%) of Tier 1 Capital in private equity and hedge funds (known as the "Volcker Rule"). The FRB released a final rule on February 9, 2011 (effective on April 1, 2011) which requires a "banking entity", a term that is defined to include bank holding companies like First United Corporation and banks like the Bank, to bring its proprietary trading activities and investments into compliance with the Dodd-Frank Act restrictions no later than two years after the earlier of: (i) July 21, 2012; or (ii) 12 months after the date on which interagency final rules are adopted. Pursuant to the compliance date final rule, banking entities are permitted to request an extension of this timeframe from the FRB. On October 11, 2011, the federal banking agencies released for comment proposed regulations implementing the Volcker Rule. The public comment period closed on February 13, 2012 and a final rule has not yet been published. The proposal has been criticized and there is no consensus as to what the provisions will ultimately include. First United Corporation intends to review the implications of the interagency rules on its investments once those rules are issued and will plan for any adjustments of its activities or its holdings so that it will be in compliance by the announced compliance date.

Federal Securities Laws and NASDAQ Rules

The shares of common stock of First United Corporation are registered with the SEC under Section 12(b) of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), and listed on the NASDAQ Global Select Market. First United Corporation is subject to information reporting requirements, proxy solicitation requirements, insider trading restrictions and other requirements of the Exchange Act, including the requirements imposed under the federal Sarbanes-Oxley Act of 2002, and rules adopted by NASDAQ. Among other things, loans to and other transactions with insiders are subject to restrictions and heightened disclosure, directors and certain committees of the Board must satisfy certain independence requirements, First United Corporation must comply with certain enhanced corporate governance requirements, and various issuances of securities by First United Corporation require shareholder approval.

Governmental Monetary and Credit Policies and Economic Controls

The earnings and growth of the banking industry and ultimately of the Bank are affected by the monetary and credit policies of governmental authorities, including the FRB. An important function of the FRB is to regulate the national supply of bank credit in order to control recessionary and inflationary pressures. Among the instruments of monetary policy used by the FRB to implement these objectives are open market operations in U.S. Government securities, changes in the federal funds rate, changes in the discount rate of member bank borrowings, and changes in reserve requirements against member bank deposits. These means are used in varying combinations to influence overall growth of bank loans, investments and deposits and may also affect interest rates charged on loans or paid on deposits. The monetary policies of the FRB authorities have had a significant effect on the operating results of commercial banks in the past and are expected to continue to have such an effect in the future. In view of changing conditions in the national economy and in the money markets, as well as the effect of actions by monetary and fiscal authorities, including the FRB, no prediction can be made as to possible future changes in interest rates, deposit levels, loan demand or their effect on our businesses and earnings.

SEASONALITY

Management does not believe that our business activities are seasonal in nature. Deposit, loan, and insurance demand may vary depending on local and national economic conditions, but management believes that any variation will not have a material impact on our planning or policy-making strategies.

EMPLOYEES

At December 31, 2012, we employed 398 individuals, of whom 316 were full-time employees.

ITEM 1A. RISK FACTORS

The significant risks and uncertainties related to us, our business and our securities of which we are aware are discussed below. You should carefully consider these risks and uncertainties before making investment decisions in respect of our securities. Any of these factors could materially and adversely affect our business, financial condition, operating results and prospects and could negatively impact the market price of our securities. If any of these risks materialize, you could lose all or part of your investment in First United Corporation. Additional risks and uncertainties that we do not yet know of, or that we currently think are immaterial, may also impair our business operations. You should also consider the other information contained in this annual report, including our financial statements and the related notes, before making investment decisions in respect of our securities.

Risks Relating to First United Corporation and its Affiliates

First United Corporation’s future success depends on the successful growth of its subsidiaries.

First United Corporation’s primary business activity for the foreseeable future will be to act as the holding company of the Bank and its other direct and indirect subsidiaries. Therefore, First United Corporation’s future profitability will depend on the success and growth of these subsidiaries. In the future, part of our growth may come from buying other banks and buying or establishing other companies. Such entities may not be profitable after they are purchased or established, and they may lose money, particularly at first. A new bank or company may bring with it unexpected liabilities, bad loans, or bad employee relations, or the new bank or company may lose customers.

Interest rates and other economic conditions will impact our results of operations.

Our results of operations may be materially and adversely affected by changes in prevailing economic conditions, including declines in real estate values, rapid changes in interest rates and the monetary and fiscal policies of the federal government. Our profitability is in part a function of the spread between the interest rates earned on assets and the interest rates paid on deposits and other interest-bearing liabilities (*i.e.*, net interest income), including advances from the Federal Home Loan Bank of Atlanta (the "FHLB"). Interest rate risk arises from mismatches (*i.e.*, the interest sensitivity gap) between the dollar amount of repricing or maturing assets and liabilities. If more assets reprice or mature than liabilities during a falling interest rate environment, then our earnings could be negatively impacted. Conversely, if more liabilities reprice or mature than assets during a rising interest rate environment, then our earnings could be negatively impacted. Fluctuations in interest rates are not predictable or controllable. There can be no assurance that our attempts to structure our asset and liability management strategies to mitigate the impact on net interest income of changes in market interest rates will be successful in the event of such changes.

The majority of our business is concentrated in Maryland and West Virginia, much of which involves real estate lending, so a decline in the real estate and credit markets could materially and adversely impact our financial condition and results of operations.

Most of the Bank's loans are made to borrowers located in Western Maryland and Northeastern West Virginia, and many of these loans, including construction and land development loans, are secured by real estate. Approximately 15%, or $128 million, of total loans are real estate acquisition construction and development projects that are secured by real estate. Accordingly, a decline in local economic conditions would likely have an adverse impact on our financial condition and results of operations, and the impact on us would likely be greater than the impact felt by larger financial institutions whose loan portfolios are geographically diverse. We cannot guarantee that any risk management practices we implement to address our geographic and loan concentrations will be effective to prevent losses relating to our loan portfolio.

The national and local economies were significantly and adversely impacted by the banking crisis and resulting economic recession that began around 2008, and these conditions have caused, and continue to cause, a host of challenges for financial institutions, including the Bank. For example, these conditions have made it more difficult for real estate owners and owners of loans secured by real estate to sell their assets at desirable times and prices. Not only has this impacted the demand for credit to finance the acquisition and development of real estate, but it has also impaired the ability of banks, including the Bank, to sell real estate acquired through foreclosure. In the case of real estate acquisition, construction and development projects that we have financed, these challenging economic conditions have caused some of our borrowers to default on their loans. Because of the deterioration in the market values of real estate collateral caused by the recession, banks, including the Bank, have been unable to recover the full amount due under their loans when forced to foreclose on and sell real estate collateral. As a result, we have realized significant impairments and losses in our loan portfolio, which have materially and adversely impacted our financial condition and results of operations. These conditions and their consequences are likely to continue until the nation fully recovers from the recent economic recession. Management cannot predict the extent to which these conditions will cause future impairments or losses, nor can it provide any assurances as to when, or if, economic conditions will improve.

The Bank’s concentrations of commercial real estate loans could subject it to increased regulatory scrutiny and directives, which could force us to preserve or raise capital and/or limit future commercial lending activities.

The FRB, the FDIC, and the other federal banking regulators issued guidance in December 2006 entitled “Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices” directed at institutions who have particularly high concentrations of CRE loans within their lending portfolios. This guidance suggests that these institutions face a heightened risk of financial difficulties in the event of adverse changes in the economy and CRE markets. Accordingly, the guidance suggests that institutions whose concentrations exceed certain percentages of capital should implement heightened risk management practices appropriate to their concentration risk. The guidance provides that banking regulators may require such institutions to reduce their concentrations and/or maintain higher capital ratios than institutions with lower concentrations in CRE. All of the ratios for commercial real estate are within the guidance limits at December 31, 2012.

The Bank may experience loan losses in excess of its allowance, which would reduce our earnings.

The risk of credit losses on loans varies with, among other things, general economic conditions, the type of loan being made, the creditworthiness of the borrower over the term of the loan and, in the case of a collateralized loan, the value and marketability of the collateral for the loan. Management of the Bank maintains an allowance for loan losses based upon, among other things, historical experience, an evaluation of economic conditions and regular reviews of delinquencies and loan portfolio quality. Based upon such factors, management makes various assumptions and judgments about the ultimate collectability of the loan portfolio and provides an allowance for loan losses based upon a percentage of the outstanding balances and for specific loans when their ultimate collectability is considered questionable. If management’s assumptions and judgments prove to be incorrect and the allowance for loan losses is inadequate to absorb future losses, or if the bank regulatory authorities require us to increase the allowance for loan losses as a part of its examination process, our earnings and capital could be significantly and adversely affected. Although management continually monitors our loan portfolio and makes determinations with respect to the allowance for loan losses, future adjustments may be necessary if economic conditions differ substantially from the assumptions used or adverse developments arise with respect to our non-performing or performing loans. Material additions to the allowance for loan losses could result in a material decrease in our net income and capital, and could have a material adverse effect on our financial condition.

The market value of our investments could decline.

As of December 31, 2012, we had classified all but six of our investment securities as available-for-sale pursuant to FASB Accounting Standards Codification Topic 320, *Investments – Debt and Equity Securities*, relating to accounting for investments. Topic 320 requires that unrealized gains and losses in the estimated value of the available-for-sale portfolio be “marked to market” and reflected as a separate item in shareholders’ equity (net of tax) as accumulated other comprehensive loss. There can be no assurance that future market performance of our investment portfolio will enable us to realize income from sales of securities. Shareholders’ equity will continue to reflect the unrealized gains and losses (net of tax) of these investments. Moreover, there can be no assurance that the market value of our investment portfolio will not decline, causing a corresponding decline in shareholders’ equity.

Management believes that several factors could affect the market value of our investment portfolio. These include, but are not limited to, changes in interest rates or expectations of changes, the degree of volatility in the securities markets, inflation rates or expectations of inflation and the slope of the interest rate yield curve (the yield curve refers to the differences between shorter-term and longer-term interest rates; a positively sloped yield curve means shorter-term rates are lower than longer-term rates). Also, the passage of time will affect the market values of our investment securities, in that the closer they are to maturing, the closer the market price should be to par value. These and other factors may impact specific categories of the portfolio differently, and management cannot predict the effect these factors may have on any specific category.

Impairment of investment securities, goodwill, or deferred tax assets could require charges to earnings, which could result in a negative impact on our results of operations.

In assessing whether the impairment of investment securities is other-than-temporary, management considers the length of time and extent to which the fair value has been less than cost, the financial condition and near-term prospects of the issuer, and the intent and ability to retain our investment in the security for a period of time sufficient to allow for any anticipated recovery in fair value in the near term. See the discussion under the heading “Estimates and Critical Accounting Policies – Other-Than-Temporary Impairment of Investment Securities” in Item 7 of Part II of this annual report for further information.

Under current accounting standards, goodwill is not amortized but, instead, is subject to impairment tests on at least an annual basis or more frequently if an event occurs or circumstances change that reduce the fair value of a reporting unit below its carrying amount. A decline in the price of First United Corporation’s common stock or occurrence of a triggering event following any of our quarterly earnings releases and prior to the filing of the periodic report for that period could, under certain circumstances, cause us to perform a goodwill impairment test and result in an impairment charge being recorded for that period which was not reflected in such earnings release. In the event that we conclude that all or a portion of our goodwill may be impaired, a non-cash charge for the amount of such impairment would be recorded to earnings. Such a charge would have no impact on tangible capital. At December 31, 2012, we had recorded goodwill of $11.0 million, representing approximately 11% of shareholders’ equity. See the discussion under the heading “Estimates and Critical Accounting Policies – Goodwill” in Item 7 of Part II of this annual report for further information.

In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. Assessing the need for, or the sufficiency of, a valuation allowance requires management to evaluate all available evidence, both negative and positive, including the recent trend of quarterly earnings. Positive evidence necessary to overcome the negative evidence includes whether future taxable income in sufficient amounts and character within the carryback and carry forward periods is available under the tax law, including the use of tax planning strategies. When negative evidence (*e.g.*, cumulative losses in recent years, history of operating loss or tax credit carry forwards expiring unused) exists, more positive evidence than negative evidence will be necessary. At December 31, 2012, our net deferred tax assets were approximately $28.9 million.

The impact of each of these impairment matters could have a material adverse effect on our business, results of operations, and financial condition.

We operate in a competitive environment, and our inability to effectively compete could adversely and materially impact our financial condition and results of operations.

We operate in a competitive environment, competing for loans, deposits, and customers with commercial banks, savings associations and other financial entities. Competition for deposits comes primarily from other commercial banks, savings associations, credit unions, money market and mutual funds and other investment alternatives. Competition for loans comes primarily from other commercial banks, savings associations, mortgage banking firms, credit unions and other financial intermediaries. Competition for other products, such as securities products, comes from other banks, securities and brokerage companies, and other non-bank financial service providers in our market area. Many of these competitors are much larger in terms of total assets and capitalization, have greater access to capital markets, and/or offer a broader range of financial services than those that we offer. In addition, banks with a larger capitalization and financial intermediaries not subject to bank regulatory restrictions have larger lending limits and are thereby able to serve the needs of larger customers.

In addition, changes to the banking laws over the last several years have facilitated interstate branching, merger and expanded activities by banks and holding companies. For example, the GLB Act revised the BHC Act and repealed the affiliation provisions of the Glass-Steagall Act of 1933, which, taken together, limited the securities and other non-banking activities of any company that controls an FDIC insured financial institution. As a result, the ability of financial institutions to branch across state lines and the ability of these institutions to engage in previously-prohibited activities are now accepted elements of competition in the banking industry. These changes may bring us into competition with more and a wider array of institutions, which may reduce our ability to attract or retain customers. Management cannot predict the extent to which we will face such additional competition or the degree to which such competition will impact our financial conditions or results of operations.

The banking industry is heavily regulated; significant regulatory changes could adversely affect our operations.

Our operations will be impacted by current and future legislation and by the policies established from time to time by various federal and state regulatory authorities. First United Corporation is subject to supervision by the FRB. The Bank is subject to supervision and periodic examination by the Maryland Commissioner of Financial Regulation, the West Virginia Division of Banking, and the FDIC. Banking regulations, designed primarily for the safety of depositors, may limit a financial institution’s growth and the return to its investors by restricting such activities as the payment of dividends, mergers with or acquisitions by other institutions, investments, loans and interest rates, interest rates paid on deposits, expansion of branch offices, and the offering of securities or trust services. First United Corporation and the Bank are also subject to capitalization guidelines established by federal law and could be subject to enforcement actions to the extent that either is found by regulatory examiners to be undercapitalized. It is not possible to predict what changes, if any, will be made to existing federal and state legislation and regulations or the effect that such changes may have on our future business and earnings prospects. Management also cannot predict the nature or the extent of the effect on our business and earnings of future fiscal or monetary policies, economic controls, or new federal or state legislation. Further, the cost of compliance with regulatory requirements may adversely affect our ability to operate profitably.

The full impact of the recently enacted Dodd-Frank Act is currently unknown given that many of the details and substance of the new laws will be implemented through agency rulemakings, but it will likely materially increase our regulatory expenses.

On July 21, 2010, the Dodd-Frank Act was signed into law. The Dodd-Frank Act represents a comprehensive overhaul of the financial services industry within the United States and requires federal agencies to adopt nearly 250 new rules and conduct more than 60 studies over the course of the next few years, ensuring that the federal regulations and implementing policies in these areas will continue to develop for the foreseeable future.

Significantly, the Dodd-Frank Act includes the following provisions which affect First United Corporation and/or the Bank:

- It established the CFPB, which directly regulates and supervises the Bank for compliance with the CFPB's regulations and policies. The creation of the CFPB will directly impact the scope and cost of products and services offered to consumers by the Bank and may have a significant effect on its financial performance.
- It revised the FDIC's insurance assessment methodology so that premiums are assessed based upon the average consolidated total assets of the Bank less tangible equity capital.
- It permanently increased deposit insurance coverage to $250,000.
- It authorized the FRB to set debit interchange fees in an amount that is "reasonable and proportional" to the costs incurred by processors and card issuers. Under the final rule issued by the FRB, there is a cap of $0.21 per transaction (with a maximum of $.24 per transaction permitted if certain requirements are met). Implementation of these caps went into effect on October 1, 2011.
- It imposes proprietary trading restrictions on insured depository institutions and their holding companies that prohibit them from engaging in proprietary trading except in limited circumstances, and prevents them from owning equity interests in excess of three percent (3%) of a bank's Tier 1 capital in private equity and hedge funds.
- It requires a phased-in exclusion of trust preferred securities as a component of Tier 1 capital for certain bank holding companies.

- Depository institution holding companies must now act as a "source of strength" for their depository institution subsidiaries (previously, this had been limited to regulatory policy).
- Pursuant to the Dodd-Frank Act, the CFPB recently issued a final rule requiring mortgage lenders to make a reasonable and good faith determination based on verified and documented information that a consumer applying for a mortgage loan has a reasonable ability to repay the loan according to its terms, or to originate "qualified mortgages" that meet specific requirements with respect to terms, pricing and fees. The new rule also contains new disclosure requirements at mortgage loan origination and in monthly statements. These requirements will likely require significant personnel resources and could have a material adverse effect on our operations.

Based on the text of the Dodd-Frank Act and the implementing regulations (both published and yet-to-be-published), it is anticipated that the costs to banks and their holding companies may increase or fee income may decrease significantly, which could adversely affect our results of operations, financial condition and/or liquidity. Moreover, compliance obligations will expose us to additional noncompliance risk and could divert management's focus from the business of banking.

The Consumer Financial Protection Bureau may reshape the consumer financial laws through rulemaking and enforcement of the prohibitions against unfair, deceptive and abusive business practices. Compliance with any such change may impact our business operations.

The CFPB has broad rulemaking authority to administer and carry out the provisions of the Dodd-Frank Act with respect to financial institutions that offer covered financial products and services to consumers. The CFPB has also been directed to write rules identifying practices or acts that are unfair, deceptive or abusive in connection with any transaction with a consumer for a consumer financial product or service, or the offering of a consumer financial product or service. The concept of what may be considered to be an "abusive" practice is new under the law. The full scope of the impact of this authority has not yet been determined as the CFPB has not yet released significant supervisory guidance. Moreover, the Bank will be supervised and examined by the CFPB for compliance with the CFPB's regulations and policies.

The costs and limitations related to this additional regulatory reporting regimen have yet to be fully determined, although they may be material and the limitations and restrictions that will be placed upon the Bank with respect to its consumer product offering and services may produce significant, material effects on our profitability. As of the date of this annual report, the CFPB has not examined the Bank.

Bank regulators and other regulations, including proposed Basel III capital standards, may require higher capital levels, impacting our ability to pay dividends or repurchase our stock.

In June 2012, the U.S. federal banking agencies issued three Notices of Proposed Rulemaking that would revise and replace the agencies' current capital rules to align with the BASEL III capital standards and meet certain requirements of the Dodd-Frank Act. Certain requirements of the proposed rules would establish more restrictive capital definitions, higher risk-weightings for certain asset classes, capital buffers, and higher minimum capital ratios. The proposed rules were in a comment period through October 22, 2012 and are subject to further modification by the agencies, as the release of the final rules has been deferred indefinitely. See the section entitled "Capital Resources" in Item 7 of Part II of this annual report for further information. If adopted, our ability to use our capital resources could be materially limited and/or we could be required to raise additional capital by issuing common stock. The issuance of additional shares of common stock may dilute existing shareholders.

We may be adversely affected by other recent legislation.

As discussed above, the GLB Act repealed restrictions on banks affiliating with securities firms and it also permitted certain bank holding companies to become financial holding companies. Financial holding companies are permitted to engage in a host of financial activities, and activities that are incidental to financial activities, that are not permitted for bank holding companies who have not elected to become financial holding companies, including insurance and securities underwriting and agency activities, merchant banking, and insurance company portfolio investment activities. Although we are a financial holding company, this law may increase the competition we face from larger banks and other companies, especially considering the fact that we have agreed with the FRB to not engage in additional financial holding company activities until the Bank is considered both "well capitalized" and "well managed". It is not possible to predict the full effect that the GLB Act will have on us.

The federal Sarbanes-Oxley Act of 2002 requires management of every publicly traded company to perform an annual assessment of the company's internal control over financial reporting and to report on whether the system is effective as of the end of the company's fiscal year. If our management were to discover and report significant deficiencies or material weaknesses in our internal control over financial reporting, then the market value of our securities and shareholder value could decline.

The Patriot Act requires certain financial institutions, such as the Bank, to maintain and prepare additional records and reports that are designed to assist the government's efforts to combat terrorism. This law includes sweeping anti-money laundering and financial transparency laws and required additional regulations, including, among other things, standards for verifying client identification when opening an account and rules to promote cooperation among financial institutions, regulators and law enforcement entities in identifying parties that may be involved in terrorism or money laundering. If we fail to comply with this law, we could be exposed to adverse publicity as well as fines and penalties assessed by regulatory agencies.

Customer concern about deposit insurance may cause a decrease in deposits held at the Bank.

With increased concerns about bank failures, customers increasingly are concerned about the extent to which their deposits are insured by the FDIC. Customers may withdraw deposits from the Bank in an effort to ensure that the amount they have on deposit with us is fully insured. Decreases in deposits may adversely affect our funding costs and net income.

The Bank's funding sources may prove insufficient to replace deposits and support our future growth.

The Bank relies on customer deposits, advances from the FHLB, lines of credit at other financial institutions and brokered funds to fund our operations. Although the Bank has historically been able to replace maturing deposits and advances if desired, no assurance can be given that the Bank would be able to replace such funds in the future if our financial condition or the financial condition of the FHLB or market conditions were to change. Our financial flexibility will be severely constrained and/or our cost of funds will increase if we are unable to maintain our access to funding or if financing necessary to accommodate future growth is not available at favorable interest rates. Finally, if we are required to rely more heavily on more expensive funding sources to support future growth, our revenues may not increase proportionately to cover our costs. In this case, our profitability would be adversely affected.

Recent rulemaking efforts by the FRB may negatively impact our non-interest income.

On November 12, 2009, the FRB announced the final rules amending Regulation E that prohibit financial institutions from charging fees to consumers for paying overdrafts on automated teller machine and one-time debit card transactions, unless a consumer consents, or opts-in, to the overdraft service for those types of transactions. Compliance with this regulation is effective July 1, 2010 for new consumer accounts and August 15, 2010 for existing consumer accounts. These new rules negatively impacted the Banks' non-interest income in 2011 and 2012 and may do the same in future periods.

In addition, the FRB has issued rules pursuant to the Dodd-Frank Act governing debit card interchange fees that apply to institutions with greater than $10 billion in assets. Although we are not subject to these rules, market forces may effectively require all banks to adopt debit card interchange fee structures that comply with these rules, in which case our non-interest income for future periods could be materially and adversely affected.

The loss of key personnel could disrupt our operations and result in reduced earnings.

Our growth and profitability will depend upon our ability to attract and retain skilled managerial, marketing and technical personnel. Competition for qualified personnel in the financial services industry is intense, and there can be no assurance that we will be successful in attracting and retaining such personnel. Our current executive officers provide valuable services based on their many years of experience and in-depth knowledge of the banking industry and the market areas we serve. Due to the intense competition for financial professionals, these key personnel would be difficult to replace and an unexpected loss of their services could result in a disruption to the continuity of operations and a possible reduction in earnings.

The Bank's lending activities subject the Bank to the risk of environmental liabilities.

A significant portion of the Bank's loan portfolio is secured by real property. During the ordinary course of business, the Bank may foreclose on and take title to properties securing certain loans. In doing so, there is a risk that hazardous or toxic substances could be found on these properties. If hazardous or toxic substances are found, the Bank may be liable for remediation costs, as well as for personal injury and property damage. Environmental laws may require the Bank to incur substantial expenses and may materially reduce the affected property's value or limit the Bank's ability to use or sell the affected property. In addition, future laws or more stringent interpretations or enforcement policies with respect to existing laws may increase the Bank's exposure to environmental liability. Although the Bank has policies and procedures to perform an environmental review before initiating any foreclosure action on real property, these reviews may not be sufficient to detect all potential environmental hazards. The remediation costs and any other financial liabilities associated with an environmental hazard could have a material adverse effect on our financial condition and results of operations.

We may be subject to claims and the costs of defensive actions, and such claims and costs could materially and adversely impact our financial condition and results of operations.

Our customers may sue us for losses due to alleged breaches of fiduciary duties, errors and omissions of employees, officers and agents, incomplete documentation, our failure to comply with applicable laws and regulations, or many other reasons. Also, our employees may knowingly or unknowingly violate laws and regulations. Management may not be aware of any violations until after their occurrence. This lack of knowledge may not insulate us from liability. Claims and legal actions will result in legal expenses and could subject us to liabilities that may reduce our profitability and hurt our financial condition.

We may not be able to keep pace with developments in technology.

We use various technologies in conducting our businesses, including telecommunication, data processing, computers, automation, internet-based banking, and debit cards. Technology changes rapidly. Our ability to compete successfully with other financial institutions may depend on whether we can exploit technological changes. We may not be able to exploit technological changes, and any investment we do make may not make us more profitable.

Safeguarding our business and customer information increases our cost of operations. To the extent that we, or our third party vendors, are unable to prevent the theft of or unauthorized access to this information, our operations may become disrupted, we may be subject to claims, and our net income may be adversely affected.

Our business depends heavily on the use of computer systems, the Internet and other means of electronic communication and recordkeeping. Accordingly, we must protect our computer systems and network from break-ins, security breaches, and other risks that could disrupt our operations or jeopardize the security of our business and customer information. Moreover, we use third party vendors to provide products and services necessary to conduct our day-to-day operations, which exposes us to risk that these vendors will not perform in accordance with the service arrangements, including by failing to protect the confidential information we entrust to them. Any security measures that we or our vendors implement, including encryption and authentication technology that we use to effect secure transmissions of confidential information, may not be effective to prevent the loss or theft of our information or to prevent risks associated with the Internet, such as cyber-fraud. Advances in computer capabilities, new discoveries in the field of cryptography, or other developments could permit unauthorized persons to gain access to our confidential information in spite of the use of security measures that we believe are adequate. Any compromise of our security measures or of the security measures employed by our vendors of our third party could disrupt our business and/or could subject us to claims from our customers, either of which could have a material adverse effect on our business, financial condition and results of operations.

We may lose key personnel because of our participation in the Troubled Asset Relief Program Capital Purchase Program.

On January 30, 2009, First United Corporation participated in the Troubled Asset Relief Program ("TARP") Capital Purchase Program (the "CPP") adopted by the U.S. Department of Treasury ("Treasury") by selling 30,000 shares of First United Corporation's Fixed Rate Cumulative Perpetual Preferred Stock, Series A (the "Series A Preferred Stock") to Treasury and issuing a 10-year common stock purchase warrant (the "Warrant") to Treasury, for a total consideration of $30 million. As part of these transactions, First United Corporation adopted the Treasury's standards for executive compensation and corporate governance for the period during which the Treasury holds any shares of the Series A Preferred Stock and/or any shares of common stock acquired upon exercise of the warrant. On February 17, 2009, the American Reinvestment and Recovery Act of 2009 (the "Recovery Act") was signed into law, which, among other things, imposed additional executive compensation restrictions on institutions that participate in the TARP CPP for so long as any TARP CPP assistance remains outstanding. Among these restrictions is a prohibition against making most severance payments to our "senior executive officers" (our Chairman and Chief Executive Officer and the two next most highly compensated executive officers) and to our next five most highly compensated employees. The restrictions also limit the type, timing and amount of bonuses, retention awards and incentive compensation that may be paid to certain employees. These restrictions, coupled with the competition we face from other institutions, including institutions that do not participate in TARP, may make it more difficult for us to attract and/or retain exceptional key employees.

Because First United Corporation has failed to make six quarterly dividend payments on the Series A Preferred Stock, the holders thereof have the right to elect up to two additional directors to First United Corporation's Board of Directors.

Subject to the declaration thereof by First United Corporation's Board of Directors, the terms of the Series A Preferred Stock provide for the payment of quarterly cash dividends on February 15th, May 15th, August 15th and November 15th of each year. Dividends will accrue regardless of whether the board declares a dividend on any such date. The terms further provide that whenever, at any time or times, dividends payable on the outstanding shares of the Series A Preferred Stock have not been paid for an aggregate of six quarterly dividend periods or more, whether or not consecutive, the authorized number of directors then constituting First United Corporation's Board of Directors will automatically be increased by two, from 14 directors to 16 directors (based on the current board structure). Thereafter, holders of the Series A Preferred Stock, together with holders of any outstanding stock having voting rights similar to the Series A Preferred Stock, voting as a single class, will be entitled to fill the vacancies created by the automatic increase by electing up to two additional directors (the "Preferred Stock Directors") at the next annual meeting (or at a special meeting called for the purpose of electing the Preferred Stock Directors prior to the next annual meeting) and at each subsequent annual meeting until all accrued and unpaid dividends for all past dividend periods have been paid in full. First United Corporation currently does not have any outstanding stock with voting rights on par with the Series A Preferred Stock. As discussed below, First United Corporation has deferred the payment of cash dividends on the Series A Preferred Stock for more than six quarterly dividend periods, since November 15, 2010. If the Treasury were to inform First United Corporation that it intends to elect Preferred Stock Directors, then the holders of the common stock would not be entitled to vote on the election of those Preferred Stock Directors.

Risks Relating to First United Corporation's Securities

The shares of common stock, Series A Preferred Stock, and the Warrant are not insured.

The shares of First United Corporation's common stock, including the shares underlying the Warrant, the shares of the Series A Preferred Stock, and the Warrant are not deposits and are not insured against loss by the FDIC or any other governmental or private agency.

First United Corporation is prohibited from declaring or paying cash dividends on its outstanding capital securities and management cannot predict if or when First United Corporation will again have the ability to pay dividends.

As discussed in the next three risk factors, First United Corporation has deferred the payment of cash dividends and interest under certain of its outstanding securities and is, therefore, currently prohibited from declaring or paying any cash dividends on any of its outstanding capital securities.

First United Corporation and the Bank have entered into informal agreements with their regulators that limit their ability to pay dividends and make other distributions on outstanding securities.

First United Corporation has entered into an informal agreement with the Federal Reserve Bank of Richmond (the "Reserve Bank") pursuant to which it agreed not to pay dividends on outstanding shares of its common stock or on outstanding shares of its Series A Preferred Stock or make interest payments under the junior subordinated debentures (the "TPS Debentures"), underlying the trust preferred securities issued by its trust subsidiaries, First United Statutory Trust I ("Trust I"), First United Statutory Trust II ("Trust II") and First United Statutory Trust III ("Trust III" and, together with Trust I and Trust II, the "Trusts"), or take any other action that reduces regulatory capital without the prior approval of the Reserve Bank. The Bank has entered into a similar agreement with the FDIC and the Maryland Commissioner. These agreements give our regulators the ability to prohibit a proposed dividend payment, or any other distribution with respect to outstanding securities, including the repurchase of stock, at a time or times when applicable banking and corporate laws would otherwise permit such a dividend or distribution. There is no requirement that our regulators take consistent approaches when exercising their powers under these agreements. For example, even though the Reserve Bank might approve the payment of a particular dividend, that dividend could be effectively prohibited by the FDIC and/or the Maryland Commissioner if First United Corporation intended to fund that dividend through a dividend by the Bank and the FDIC and/or the Maryland Commissioner were to deny the Bank's dividend request. Similarly, even though the FDIC and the Maryland Commissioner might approve a dividend by the Bank to First United Corporation, the Reserve Bank could prevent the Corporation from using that dividend to make a distribution to the holders of its outstanding common stock, Series A Preferred Stock, or outstanding TPS Debentures. These agreements increase the likelihood that we will realize the other risks discussed below related to our ability to pay dividends and make other distributions.

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The terms of the Series A Preferred Stock limit First United Corporation's ability to pay dividends and make other distributions on its capital securities, and First United Corporation's deferral of dividend payments under the Series A Preferred Stock has triggered additional dividend restrictions.

In January 2009, First United Corporation issued and sold 30,000 shares of its Series A Preferred Stock to the U.S. Department of the Treasury (the "Treasury") pursuant to the Treasury's Troubled Asset Relief Program Capital Purchase Program. The terms of the Series A Preferred Stock permit First United Corporation to defer regular quarterly dividends. However, during any period that First United is in arrears on any quarterly cash dividend due on the outstanding shares of the Series A Preferred Stock, it will be prohibited from declaring or paying dividends on shares of its common stock, other stock ranking junior to the Series A Preferred Stock, or preferred stock ranking on a parity with the Series A Preferred Stock, or from repurchasing shares of such common stock, junior stock or parity stock. On November 15, 2010, at the request of the Reserve Bank pursuant to its agreement, First United Corporation elected to defer regularly scheduled quarterly cash dividend payments under the Series A Preferred Stock, starting with the dividend payment due November 15, 2010. As a result, First United Corporation is currently prohibited from declaring or paying dividends or making other distributions on, or repurchasing, redeeming or otherwise acquiring, shares of its common stock. First United Corporation cannot predict when, or if, it will be able to pay accrued and future dividends on the Series A Preferred Stock or, thus, the common stock.

First United Corporation's ability to pay dividends on its capital securities is also subject to the terms of the outstanding TPS Debentures, and First United Corporation's deferral of interest payments under the TPS Debentures has also triggered dividend restrictions.

In March 2004, First United Corporation issued approximately $30.9 million of TPS Debentures to Trust I and Trust II in connection with the sales by those Trusts of $30.0 in mandatorily redeemable preferred capital securities to third party investors. Between December 2009 and January 2010, First United Corporation issued approximately $10.8 million of TPS Debentures to Trust III in connection with the sale by Trust III of approximately $10.5 million in mandatorily redeemable preferred capital securities to third party investors. The terms of the TPS Debentures require First United Corporation to make quarterly payments of interest to the holders of the TPS Debentures, although it has the right to defer payments of interest for up to 20 consecutive quarterly periods. If First United Corporation elects to defer the payment of regularly scheduled interest payments under the TPS Debentures, the terms of the TPS Debentures will prohibit First United from declaring or paying dividends or making other distributions on, or repurchasing, redeeming or otherwise acquiring, any shares of the common stock or the Series A Preferred Stock. On December 15, 2010, at the request of the Reserve Bank pursuant to its agreement, First United Corporation elected to defer regularly scheduled quarterly interest payments under the TPS Debentures, starting with the interest payments due in March 2011, and this deferral requires the Trusts to defer regular quarterly dividend payments on their trust preferred securities. As a result, First United Corporation is currently prohibited from declaring or paying cash dividends or making other distributions on, or repurchasing, redeeming or otherwise acquiring, outstanding shares of its common stock or Series A Preferred Stock. First United Corporation cannot predict when, or if, it will be able to pay accrued and future interest due under the TPS Debentures.

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Applicable banking and Maryland laws impose additional restrictions on the ability of First United Corporation and the Bank to pay dividends and make other distributions on their capital securities, and, in any event, the payment of dividends is at the discretion of the boards of directors of First United Corporation and the Bank.

In the past, First United Corporation's ability to pay dividends to shareholders has been largely dependent upon the receipt of dividends from the Bank. Since December 2009, First United Corporation has used its cash to pay dividends. In December 2010, however, First United Corporation contributed substantially all of its excess cash to the Bank to strengthen the Bank's capital levels. Accordingly, in the event that First United Corporation desires to pay cash dividends on the common stock and/or the Series A Preferred Stock in the future, and assuming such dividends are then permitted under the terms of the Series A Preferred Stock and the TPS Debentures, First United Corporation will likely need to rely on dividends from the Bank to pay such dividends, and there can be no guarantee that the Bank will be able to pay such dividends. Both federal and state laws impose restrictions on the ability of the Bank to pay dividends. Under Maryland law, a state-chartered commercial bank may pay dividends only out of undivided profits or, with the prior approval of the Maryland Commissioner, from surplus in excess of 100% of required capital stock. If, however, the surplus of a Maryland bank is less than 100% of its required capital stock, cash dividends may not be paid in excess of 90% of net earnings. In addition to these specific restrictions, bank regulatory agencies have the ability to prohibit proposed dividends by a financial institution which would otherwise be permitted under applicable regulations if the regulatory body determines that such distribution would constitute an unsafe or unsound practice. Banks that are considered "troubled institution" are prohibited by federal law from paying dividends altogether. Notwithstanding the foregoing, shareholders must understand that the declaration and payment of dividends and the amounts thereof are at the discretion of First United Corporation's Board of Directors. Thus, even at times when First United Corporation is not prohibited from paying cash dividends on its capital securities, neither the payment of such dividends nor the amounts thereof can be guaranteed.

There is no market for the Series A Preferred Stock or the Warrant, and the common stock is not heavily traded.

There is no established trading market for the shares of the Series A Preferred Stock or the Warrant. First United Corporation does not intend to apply for listing of the Series A Preferred Stock on any securities exchange or for inclusion of the Series A Preferred Stock in any automated quotation system unless requested by the Treasury. The common stock is listed on the NASDAQ Global Select Market, but shares of the common stock are not heavily traded. Securities that are not heavily traded can be more volatile than stock trading in an active public market. Factors such as our financial results, the introduction of new products and services by us or our competitors, and various factors affecting the banking industry generally may have a significant impact on the market price of the shares the common stock. Management cannot predict the extent to which an active public market for any of First United Corporation's securities will develop or be sustained in the future. Accordingly, holders of First United Corporation's securities may not be able to sell such securities at the volumes, prices, or times that they desire.

First United Corporation's Articles of Incorporation and Bylaws and Maryland law may discourage a corporate takeover.

First United Corporation's Amended and Restated Articles of Incorporation (the "Charter") and its Amended and Restated Bylaws, as amended (the "Bylaws") contain certain provisions designed to enhance the ability of First United Corporation's Board of Directors to deal with attempts to acquire control of First United Corporation. First, the Board of Directors is classified into three classes. Directors of each class serve for staggered three-year periods, and no director may be removed except for cause, and then only by the affirmative vote of either a majority of the entire Board of Directors or a majority of the outstanding voting stock. Second, the board has the authority to classify and reclassify unissued shares of stock of any class or series of stock by setting, fixing, eliminating, or altering in any one or more respects the preferences, rights, voting powers, restrictions and qualifications of, dividends on, and redemption, conversion, exchange, and other rights of, such securities. The board could use this authority, along with its authority to authorize the issuance of securities of any class or series, to issue shares having terms favorable to management to a person or persons affiliated with or otherwise friendly to management. In addition, the Bylaws require any shareholder who desires to nominate a director to abide by strict notice requirements.

Maryland law also contains anti-takeover provisions that apply to First United Corporation. The Maryland Business Combination Act generally prohibits, subject to certain limited exceptions, corporations from being involved in any "business combination" (defined as a variety of transactions, including a merger, consolidation, share exchange, asset transfer or issuance or reclassification of equity securities) with any "interested shareholder" for a period of five years following the most recent date on which the interested shareholder became an interested shareholder. An interested shareholder is defined generally as a person who is the beneficial owner of 10% or more of the voting power of the outstanding voting stock of the corporation after the date on which the corporation had 100 or more beneficial owners of its stock or who is an affiliate or associate of the corporation and was the beneficial owner, directly or indirectly, of 10% percent or more of the voting power of the then outstanding stock of the corporation at any time within the two-year period immediately prior to the date in question and after the date on which the corporation had 100 or more beneficial owners of its stock. The Maryland Control Share Acquisition Act applies to acquisitions of "control shares", which, subject to certain exceptions, are shares the acquisition of which entitle the holder, directly or indirectly, to exercise or direct the exercise of the voting power of shares of stock of the corporation in the election of directors within any of the following ranges of voting power: one-tenth or more, but less than one-third of all voting power; one-third or more, but less than a majority of all voting power or a majority or more of all voting power. Control shares have limited voting rights.

Although these provisions do not preclude a takeover, they may have the effect of discouraging, delaying or deferring a tender offer or takeover attempt that a shareholder might consider in his or her best interest, including those attempts that might result in a premium over the market price for the common stock. Such provisions will also render the removal of the Board of Directors and of management more difficult and, therefore, may serve to perpetuate current management. These provisions could potentially adversely affect the market prices of First United Corporation’s securities.

ITEM 1B. UNRESOLVED STAFF COMMENTS

This Item 1B is not applicable because First United Corporation is a “smaller reporting company”.

ITEM 2. PROPERTIES

The headquarters of First United Corporation and the Bank occupies approximately 29,000 square feet at 19 South Second Street, Oakland, Maryland, a 30,000 square feet operations center located at 12892 Garrett Highway, Oakland Maryland and 8,500 square feet at 102 South Second Street, Oakland, Maryland. These premises are owned by First United Corporation. The Bank owns 21 of its banking offices and leases six. The Bank also leases one office that is used for disaster recovery purposes and one specialty office. Total rent expense on the leased offices and properties was $.5 million in 2012.

ITEM 3. LEGAL PROCEEDINGS

We are at times, in the ordinary course of business, subject to legal actions. Management, upon the advice of counsel, believes that losses, if any, resulting from current legal actions will not have a material adverse effect on our financial condition or results of operations.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Shares of First United Corporation's common stock are listed on the NASDAQ Global Select Market under the symbol "FUNC". As of February 25, 2013, First United Corporation had 1,827 shareholders of record. The high and low sales prices for the shares of First United Corporation's common stock for each quarterly period of 2012 and 2011 are set forth below. On March 13, 2013, the closing sales price of the common stock as reported on the NASDAQ Global Select Market was $8.75 per share. During 2012 and 2011, First United Corporation did not declare any dividends on its common stock.

	High	Low
2012		
1st Quarter	$6.48	$3.16
2nd Quarter	8.60	4.05
3rd Quarter	7.25	4.31
4th Quarter	7.80	6.02
2011		
1st Quarter	$4.93	$2.76
2nd Quarter	6.00	2.92
3rd Quarter	5.50	3.38
4th Quarter	4.81	2.93

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The ability of the Bank to declare dividends is limited by federal and state banking laws and state corporate laws. Subject to the restrictions imposed on First United Corporation by these laws and the terms of its other securities, the payment of dividends on the shares of common stock and the amounts thereof are at the discretion of First United Corporation's Board of Directors. Prior to November 2010, cash dividends were typically declared on a quarterly basis. Historically, dividends to shareholders were generally dependent on the ability of First United Corporation's subsidiaries, especially the Bank, to declare dividends to the Corporation. As a result of First United Corporation's deferral of cash dividends under its Series A Preferred Stock in November 2010 and its December 2010 decision to defer interest payments under its TPS Debentures, the terms of these securities currently prohibit First United Corporation from declaring or paying cash dividends on outstanding shares of common stock. A complete discussion of these dividend restrictions is contained in Item 1A of Part I of this annual report under the heading "***Risks Relating to First United Corporation's Securities***" and in Note 21 to the Consolidated Financial Statements, both of which are incorporated herein by reference.

Because of these limitations and the fact that dividends are declared at the discretion of the Board, there can be no assurance that dividends will be declared in any future fiscal quarter. First United Corporation intends to periodically evaluate its dividend policy both internally and with the FRB, but it has no present intention of resuming dividend payments on its common stock in the foreseeable future.

Issuer Repurchases

Neither First United Corporation nor any of its affiliates (as defined by Exchange Act Rule 10b-18) repurchased any shares of First United Corporation's common stock during 2012.

Equity Compensation Plan Information

Pursuant to the SEC's Regulation S-K Compliance and Disclosure Interpretation 106.01, the information regarding First United Corporation's equity compensation plans required by this Item pursuant to Item 201(d) of Regulation S-K is located in Item 12 of Part III of this annual report and is incorporated herein by reference.

ITEM 6. SELECTED FINANCIAL DATA

The following table sets forth certain selected financial data for the five years ended December 31, and is qualified in its entirety by the detailed information and financial statements, including notes thereto, included elsewhere or incorporated by reference in this annual report.

(Dollars in thousands, except for share data)	2012	2011	2010	2009	2008
Balance Sheet Data					
Total Assets	$1,320,783	$1,390,865	$1,696,445	$1,743,796	$1,639,104
Net Loans	858,782	919,214	987,615	1,101,794	1,120,199
Investment Securities	227,313	245,023	229,687	273,784	354,595
Deposits	976,884	1,027,784	1,301,646	1,304,166	1,222,889
Long-term Borrowings	182,735	207,044	243,100	270,544	277,403
Shareholders' Equity	98,905	96,656	95,640	100,566	72,690
Operating Data					
Interest Income	$53,111	$59,496	$70,747	$85,342	$95,216
Interest Expense	13,965	21,206	29,164	32,104	43,043
Net Interest Income	39,146	38,290	41,583	53,238	52,173
Provision for Loan Losses	9,390	9,157	15,726	15,588	12,925
Other Operating Income	13,630	14,966	15,356	15,390	15,766
Net Securities Impairment Losses	0	(19)	(8,364)	(26,693)	(2,724)
Net Gains/(Losses) – Other	1,708	2,302	(6,014)	411	727
Other Operating Expense	39,518	43,410	45,049	46,578	40,573
Income/(Loss) Before Taxes	5,576	2,991	(18,214)	(19,820)	12,444
Income Tax expense/(benefit)	913	(635)	(8,017)	(8,496)	3,573
Net Income/(Loss)	$4,663	$3,626	$(10,197)	$(11,324)	$8,871
Accumulated preferred stock dividend and discount accretion	(1,691)	(1,609)	(1,559)	(1,430)	0
Net income available to/(loss) attributable to common shareholders	$2,972	$2,017	$(11,756)	$(12,754)	$8,871
Per Share Data					
Basic and diluted net Income/(Loss) per common share	$0.48	$0.33	$(1.91)	$(2.08)	$1.45
Dividends Paid	0	0	0.13	0.80	0.80
Book Value	11.14	10.80	10.68	11.49	11.89
Significant Ratios					
Return on Average Assets	0.34 %	0.24 %	(0.58)%	(0.67)%	0.55 %
Return on Average Equity	4.79 %	3.71 %	(10.10)%	(11.02)%	9.31 %
Dividend Payout Ratio	0 %	0 %	(7.85)%	(43.21)%	55.17 %
Average Equity to Average Assets	7.15 %	6.55 %	5.73 %	6.06 %	5.95 %
Total Risk-based Capital Ratio	14.13 %	13.05 %	11.57 %	11.20 %	12.18 %

Tier I Capital to Risk Weighted Assets	12.54	%	11.30	%	9.74	%	9.60	%	10.59	%
Tier I Capital to Average Assets	10.32	%	9.10	%	7.34	%	8.53	%	8.10	%

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

This discussion and analysis should be read in conjunction with the Consolidated Financial Statements and notes thereto for the year ended December 31, 2012, which are included in Item 8 of Part II of this annual report.

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Overview

First United Corporation is a financial holding company which, through the Bank and its non-bank subsidiaries, provides an array of financial products and services primarily to customers in four Western Maryland counties and four Northeastern West Virginia counties. Its principal operating subsidiary is the Bank, which consists of a community banking network of 27 branch offices located throughout its market areas. Our primary sources of revenue are interest income earned from our loan and investment securities portfolios and fees earned from financial services provided to customers.

Consolidated net income available to common shareholders was $3.0 million for the year ended December 31, 2012, compared to net income available to common shareholders of $2.0 million for the year ended December 31, 2011. Basic and diluted net income per common share for the year ended December 31, 2012 were $.48, compared to net income per common share of $.33 for the year ended December 31, 2011. The increase in net income for 2012 when compared to 2011 was attributable to a $.6 million increase in net interest income after provision for loan losses, a reduction of $3.9 million in other operating expenses due primarily to reductions in salaries and benefits, equipment expense and FDIC premiums. These increases were offset by a decrease in other operating income of $1.3 million attributable to the sale of the insurance agency effective January 1, 2012, a decline in net gains of $.6 million, and an increase in tax expense of $1.6 million.

Net gains for 2012 were driven by net gains realized on sales of investment securities of $1.5 million, gains on the sale of consumer mortgage loans of $.2 million and a gain of $.1 million from the sale of the assets of the Insurance Agency. The net interest margin for the year ended December 31, 2012, on a fully tax equivalent ("FTE") basis, increased to 3.30% from 2.96% for the year ended December 31, 2011.

The provision for loan losses increased to $9.4 million for the year ended December 31, 2012, compared to $9.2 million for the year ended December 31, 2011. The slightly higher provision expense was primarily due to a loan charge-off of $9.0 million on a shared national credit for an ethanol plant in western Pennsylvania during the first quarter of 2012. In addition to this charge-off, we charged off $1.1 million on a participation loan for a hotel located in Hazleton, Pennsylvania and $.9 million on a motel located in Salisbury, Maryland. Other than these specific charge-offs, we saw an improvement in the credit quality of our loan portfolio as we experienced fewer loan downgrades and lower delinquency levels. Specific allocations were made for impaired loans where management determined that the collateral supporting the loans was not adequate to cover the loan balance, and the qualitative factors affecting the allowance for loan losses (the "ALL") were adjusted based on the current economic environment and the characteristics of the loan portfolio.

Other operating income decreased $1.9 million during 2012 when compared to 2011. This decrease was attributable to a $2.4 million decline in insurance commissions, as a result of the sale of the assets of the Insurance Agency effective January 1, 2012, a slight decline in debit card income of $.1 million and a decrease of $.6 million in net gains. These declines were offset by the $.7 million one-time, tax free death benefit that occurred in March 2012, a $.2 million increase in trust department income, and an increase of $.3 million in other income.

Operating expenses decreased $3.9 million during 2012 when compared to 2011. This decrease was due to a $.4 million decline in FDIC premiums attributable to the repayment of brokered deposits and a $.7 million decline in salary expense due to the sale of the assets of the Insurance Agency. Equipment expense declined by $.4 million in 2012 compared to 2011 primarily due to reduced depreciation expense. Other real estate expenses decreased $1.5 million in 2012 when compared to 2011 primarily due to a $.5 million decrease in write-downs, an increase of $.7 in gains on sales of properties and an increase in other real estate owned ("OREO") rental income of $.3 million. Professional services declined by $.3 million and other expenses decreased by $.4 million in 2012 when compared to 2011.

Comparing December 31, 2012 to December 31, 2011, outstanding loans decreased by $63.9 million (6.8%). CRE loans decreased $37.4 million as a result of payoffs of several large loans, charge-offs of loan balances and ongoing scheduled principal payments. Commercial and industrial ("C&I") loans decreased $9.7 million and residential mortgages declined $.3 million. Acquisition and development ("A&D") loans decreased $14.5 million due to principal repayments and charge offs. The decrease in the residential mortgage portfolio was attributable to regularly scheduled principal payments on existing loans and management's decision to use secondary market outlets such as Fannie Mae for the majority of new, longer-term, fixed-rate residential loan originations. The consumer loan portfolio declined $2.0 million due to repayment activity in the indirect auto portfolio which exceeded new production due to special financing offered by the automotive manufacturers, credit unions and certain large regional banks. At December 31, 2012, approximately 60% of the commercial loan portfolio was collateralized by real estate, compared to approximately 64% at December 31, 2011.

Interest income on loans in 2012 decreased by $5.6 million (on a FTE basis) when compared to 2011 due to the continued low rate environment and the decline in loan balances during 2012. Interest income on the investment securities decreased by $1.1 million (on a FTE basis) due to reinvesting sales and calls of securities at lower rates. (Additional information on the composition of interest income is available in Table 1 that appears on page 33).

Total deposits decreased $50.9 million during 2012 when compared to deposits at December 31, 2011. The decline in deposits was due to a strategic decision to continue to use excess cash to repay wholesale deposits and FHLB advances at their stated maturities and to allow certificates of deposit for non-relationship customers to run off. Time deposits less than $100,000 declined $28.0 million while time deposits greater than $100,000 decreased $42.7 million. Retail money markets also declined by $16.8 million during 2012. These decreases were offset by an increase of $7.2 million in traditional savings accounts, $17.8 million in interest-bearing demand deposits and $11.6 million in non-interest bearing demand deposits.

Interest expense decreased $7.2 million in 2012 when compared to 2011. The decline was due to our strategic focus to shift the mix of our portfolio from higher cost certificates of deposit to core deposits during 2012.

Other Operating Income/Other Operating Expense – Other operating income, exclusive of gains, decreased $1.3 million during 2012 when compared to 2011. Service charge income and debit card income both remained stable when comparing 2012 and 2011. Bank owned life insurance income increased due to the $.7 million one-time, tax free death benefit that occurred in March 2012. Insurance commissions decreased $2.4 million due to the sale of the assets of the Insurance Agency effective January 1, 2012. The sale did not have a material impact on our financial condition or results of operations. Other income increased $.3 million in 2012 when compared to 2011 offset by a slight decline of $.1 million in debit card income. Trust department income increased $.2 million when comparing 2012 to 2011. Trust assets under management were $637 million at December 31, 2012 and $595 million at December 31, 2011.

Net gains of $1.7 million were reported through other income during 2012, compared to net gains of $2.3 million during 2011. The decrease in net gains in 2012 was primarily attributable to an increase of $.7 million in net gains on sales of investment securities offset by the $1.4 million gain on the sale of indirect auto loans in 2011.

Other operating expenses decreased $3.9 million (9.0%) for the year ended December 31, 2012 when compared to the year ended December 31, 2011. The decrease was due to a decline of $.7 million in salaries and benefits resulting primarily from a reduction of full-time equivalent employees through attrition within the Corporation and the sale of the assets of the Insurance Agency. A decline of $.4 million in FDIC premiums attributable to the repayment of brokered deposits also impacted the reduced expenses. A decrease of $.4 million in equipment expense was the result of normal depreciation during 2012 when compared to 2011. Other real estate expenses decreased $1.5 million in 2012 when compared to 2011 primarily due to a $.5 million decrease in write-downs, an increase of $.7 in gains on sales of properties and an increase in OREO rental income of $.3 million. Other miscellaneous expenses, such as legal and professional, marketing, consulting and postage, were also reduced when comparing 2012 to 2011.

Dividends – During 2012, First United Corporation did not declare or pay any dividends on the shares of its common stock due to the Board of Directors' decision in November 2010 to defer quarterly cash dividends on the Series A Preferred Stock. There were no dividends paid on the Series A Preferred Stock in 2012.

Looking Forward – We will continue to face risks and challenges in the future, including, without limitation, changes in local economic conditions in our core geographic markets, potential yield compression on loan and deposit products from existing competitors and potential new entrants in our markets, fluctuations in interest rates, and changes to existing federal and state laws and regulations that apply to banks and financial holding companies. For a more complete discussion of these and other risk factors, see Item 1A of Part I of this annual report.

Estimates and Critical Accounting Policies

This discussion and analysis of our financial condition and results of operations is based upon our Consolidated Financial Statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent liabilities. (See Note 1 to the Consolidated Financial Statements.) On an on-going basis, management evaluates estimates and bases those estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. Management believes the following critical accounting policies affect our more significant judgments and estimates used in the preparation of the Consolidated Financial Statements.

Allowance for Loan Losses, or ALL

One of our most important accounting policies is that related to the monitoring of the loan portfolio. A variety of estimates impact the carrying value of the loan portfolio, including the calculation of the ALL, the valuation of underlying collateral, the timing of loan charge-offs and the placement of loans on non-accrual status. The allowance is established and maintained at a level that management believes is adequate to cover losses resulting from the inability of borrowers to make required payment on loans. Estimates for loan losses are arrived at by analyzing risks associated with specific loans and the loan portfolio, current and historical trends in delinquencies and charge-offs, and changes in the size and composition of the loan portfolio. The analysis also requires consideration of the economic climate and direction, changes in lending rates, political conditions, legislation impacting the banking industry and economic conditions specific to Western Maryland and Northeastern West Virginia. Because the calculation of the ALL relies on management's estimates and judgments relating to inherently uncertain events, actual results may differ from management's estimates.

The ALL is also discussed below in Item 7 under the heading "Allowance for Loan Losses" and in Note 7 to the Consolidated Financial Statements.

Goodwill

Accounting Standards Codification ("ASC") Topic 350, *Intangibles – Goodwill and Other*, establishes standards for the amortization of acquired intangible assets and impairment assessment of goodwill. We have $11.0 million in recorded goodwill at December 31, 2012 that is related to the acquisition of Huntington National Bank branches that occurred in 2003 that is not subject to periodic amortization.

Goodwill arising from business combinations represents the value attributable to unidentifiable intangible elements in the business acquired. Goodwill is not amortized but is tested for impairment annually or more frequently if events or changes in circumstances indicate that the asset might be impaired. Impairment testing requires that the fair value of each of First United Corporation's reporting units be compared to the carrying amount of its net assets, including goodwill. If the estimated current fair value of the reporting unit exceeds its carrying value, no additional testing is required and an impairment loss is not recorded. Otherwise, additional testing is performed, and to the extent such additional testing results in a conclusion that the carrying value of goodwill exceeds its implied fair value, an impairment loss is recognized.

Our goodwill relates to the value inherent in the banking business, and that value is dependent upon our ability to provide quality, cost effective services in a highly competitive local market. This ability relies upon continuing investments in processing systems, the development of value-added service features and the ease of use of our services. As such, goodwill value is supported ultimately by revenue that is driven by the volume of business transacted. A decline in earnings as a result of a lack of growth or the inability to deliver cost effective services over sustained periods can lead to impairment of goodwill, which could adversely impact earnings in future periods. ASC Topic 350 requires an annual evaluation of goodwill for impairment. The determination of whether or not these assets are impaired involves significant judgments and estimates.

Throughout 2012, consistent with First United Corporation's peer group, the shares of First United Corporation common stock traded below its book value. At December 31, 2012, First United Corporation's stock price was below its tangible book value. Management believed that these circumstances could indicate the possibility of impairment. Accordingly, management consulted a third party valuation specialist to assist it with the determination of the fair value of First United Corporation, considering both the market approach (guideline public company method) and the income approach (discounted future benefits method). Due to the illiquidity in the common stock and the adverse conditions surrounding the banking industry, reliance was placed on the income approach in determining the fair value of First United Corporation. The income approach is a discounted cash flow analysis that is determined by adding (i) the present value, which is a representation of the current value of a sum that is to be received some time in the future, of the estimated net income, net of dividends paid out, that First United Corporation could generate over the next five years and (ii) the present value of a terminal value, which is a representation of the current value of an entity at a specified time in the future. The terminal value was calculated using both a price to tangible book multiple method and a capitalization method and the more conservative of the two was utilized in the fair value calculation.

Significant assumptions used in the above methods include:

- Net income from First United Corporation's forward five-year operating budget, incorporating conservative growth and mix assumptions;
- A discount rate of 10.0% based on the most recent [third quarter of 2012] Cost of Capital Report from Morningstar/Ibbotson Associates for the Commercial Banking Sector adjusted for a size and risk premium of 298 basis points;
- A price to tangible book multiple of 1.16, which was the median multiple of commercial bank mergers and acquisitions during 2012 for selling banks and holding companies with non-performing assets to average assets between 2.0% and 4.0%, as provided by Sheshunoff & Co.; and
- A capitalization rate of 7.0% (discount rate of 10.0% adjusted for a conservative growth rate of 3.0%).

The resulting fair value of the income approach resulted in the fair value of First United Corporation exceeding the carrying value by 68%. Management stressed the assumptions used in the analysis to provide additional support for the derived value. This stress testing showed that (i) the discount rate could increase to 27% before the excess would be eliminated in the tangible multiple method, and (ii) the assumption of the tangible book multiple could decline to 0.44 and still result in a fair value in excess of book value. Based on the results of the evaluation, management concluded that the recorded value of goodwill at December 31, 2012 was not impaired. However, future changes in strategy and/or market conditions could significantly impact these judgments and require adjustments to recorded asset balances. Management will continue to evaluate goodwill for impairment on an annual basis and as events occur or circumstances change.

Accounting for Income Taxes

First United Corporation accounts for income taxes in accordance with ASC Topic 740, "Income Taxes". Under this guidance, deferred taxes are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates that will apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized as income or expense in the period that includes the enactment date.

The Company regularly reviews the carrying amount of its net deferred tax assets to determine if the establishment of a valuation allowance is necessary. If based on the available evidence, it is more likely than not that all or a portion of the Company's net deferred tax assets will not be realized in future periods, a deferred tax valuation allowance would be established. Consideration is given to various positive and negative factors that could affect the realization of the deferred tax assets. In evaluating this available evidence, management considers, among other things, historical performance, expectations of future earnings, the ability to carry back losses to recoup taxes previously paid, length of statutory carry forward periods, experience with utilization of operating loss and tax credit carry forwards not expiring, tax planning strategies and timing of reversals of temporary differences. Significant judgment is required in assessing future earnings trends and the timing of reversals of temporary differences. The Company's evaluation is based on current tax laws as well as management's expectations of future performance.

Management expects that First United Corporation's adherence to the required accounting guidance may result in increased volatility in quarterly and annual effective income tax rates because of changes in judgment or measurement including changes in actual and forecasted income before taxes, tax laws and regulations, and tax planning strategies.

Other-Than-Temporary Impairment of Investment Securities

Management systematically evaluates securities for impairment on a quarterly basis. Based upon application of accounting guidance for subsequent measurement in ASC Topic 320 (Section 320-10-35), management assesses whether (i) it has the intent to sell a security being evaluated and (ii) it is more likely than not that First United Corporation will be required to sell the security prior to its anticipated recovery. If neither applies, then declines in the fair values of securities below their cost that are considered other-than-temporary declines are split into two components. The first is the loss attributable to declining credit quality. Credit losses are recognized in earnings as realized losses in the period in which the impairment determination is made. The second component consists of all other losses, which are recognized in other comprehensive loss. In estimating other-than-temporary impairment ("OTTI") losses, management considers (a) the length of time and the extent to which the fair value has been less than cost, (b) adverse conditions specifically related to the security, an industry, or a geographic area, (c) the historic and implied volatility of the fair value of the security, (d) changes in the rating of the security by a rating agency, (e) recoveries or additional declines in fair value subsequent to the balance sheet date, (f) failure of the issuer of the security to make scheduled interest or principal payments, and (g) the payment structure of the debt security and the likelihood of the issuer being able to make payments that increase in the future. Management also monitors cash flow projections for securities that are considered beneficial interests under the guidance of ASC Subtopic 325-40, *Investments – Other – Beneficial Interests in Securitized Financial Assets*, (ASC Section 325-40-35). This process is described more fully in the section of the Consolidated Balance Sheet Review entitled "Investment Securities".

Fair Value of Investments

We have determined the fair value of our investment securities in accordance with the requirements of ASC Topic 820, *Fair Value Measurements and Disclosures*, which defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements required under other accounting pronouncements. We measure the fair market values of our investments based on the fair value hierarchy established in Topic 820. The determination of fair value of investments and other assets is discussed further in Note 24 to the Consolidated Financial Statements.

Pension Plan Assumptions

Our pension plan costs are calculated using actuarial concepts, as discussed within the requirements of ASC Topic 715, *Compensation – Retirement Benefits.* Pension expense and the determination of our projected pension liability are based upon two critical assumptions: the discount rate and the expected return on plan assets. We evaluate each of these critical assumptions annually. Other assumptions impact the determination of pension expense and the projected liability including the primary employee demographics, such as retirement patterns, employee turnover, mortality rates, and estimated employer compensation increases. These factors, along with the critical assumptions, are carefully reviewed by management each year in consultation with our pension plan consultants and actuaries. Further information about our pension plan assumptions, the plan's funded status, and other plan information is included in Note 18 to the Consolidated Financial Statements.

Other than as discussed above, management does not believe that any material changes in our critical accounting policies have occurred since December 31, 2012.

Adoption of New Accounting Standards and Effects of New Accounting Pronouncements

Note 1 to the Consolidated Financial Statements discusses new accounting pronouncements that, when adopted, could affect our future consolidated financial statements.

CONSOLIDATED STATEMENT OF INCOME REVIEW

Net Interest Income

Net interest income is our largest source of operating revenue. Net interest income is the difference between the interest earned on interest-earning assets and the interest expense incurred on interest-bearing liabilities. For analytical and discussion purposes, net interest income is adjusted to a FTE basis to facilitate performance comparisons between taxable and tax-exempt assets by increasing tax-exempt income by an amount equal to the federal income taxes that would have been paid if this income were taxable at the statutorily applicable rate.

The table below summarizes net interest income (on a FTE basis) for the 2012 and 2011.

(Dollars in thousands)	2012	2011
Interest income	$54,256	$61,029
Interest expense	13,965	21,206
Net interest income	$40,291	$39,823
Net interest margin %	3.30 %	2.96 %

Net interest income on a FTE basis increased $.5 million for the year ended December 31, 2012 over the year ended December 31, 2011 due to a $7.2 million (34.1%) decrease in interest expense, which was partially offset by a $6.8 million (11.1%) decrease in interest income. The increase in net interest income was primarily due to the reduction in the average balances of interest-bearing deposits and debt outstanding as well as the reduction in the average rate paid on interest-bearing liabilities. The slightly lower yield on both loans and investment securities, as funds were reinvested and the reduction in loan balances, contributed to the decline in interest income when comparing the two periods. The reduction in the average rates on interest-bearing liabilities was the primary driver of the increase in the net interest margin of 34 basis points, as it increased to 3.30% for the year ended December 31, 2012 from 2.96% for the year ended December 31, 2011.

There was an overall $124.6 million decrease in average interest-earning assets, driven by the $45.6 million reduction in loans and the $61.5 million reduction in other interest earning assets, primarily cash, when comparing 2012 to 2011. The reduction in cash contributed to the relatively stable yield on our average earning assets.

Interest expense decreased for the year ended December 31, 2012 when compared to the year ended December 31, 2011 due to an overall reduction in interest rates on deposit products driven by our net-interest margin strategy implemented during 2011 and continuing through 2012 and our decision to only increase special rates on time deposits for full relationship customers. Management also strategically focused on shifting the mix of our deposits from higher cost certificates of deposit to core deposit products. The average balance of interest-bearing liabilities decreased by $158.3 million as management continued its strategy to deploy excess cash to repay brokered deposits and wholesale long-term borrowings at their stated maturities during 2012. The overall effect was a 42 basis point decrease in the average rate paid on our average interest-bearing liabilities, from 1.71% for the year ended December 31, 2011 to 1.29% for the year ended December 31, 2012.

As shown below, the composition of total interest income between 2012 and 2011 remained constant between interest and fees on loans and investment securities.

	% of Total Interest Income	
	2012	2011
Interest and fees on loans	88%	88 %
Interest on investment securities	11%	11 %
Other	1 %	1 %

Table 1 sets forth the average balances, net interest income and expense, and average yields and rates for our interest-earning assets and interest-bearing liabilities for 2012, 2011 and 2010. Table 2 sets forth an analysis of volume and rate changes in interest income and interest expense of our average interest-earning assets and average interest-bearing liabilities for 2012, 2011 and 2010. Table 2 distinguishes between the changes related to average outstanding balances (changes in volume created by holding the interest rate constant) and the changes related to average interest rates (changes in interest income or expense attributed to average rates created by holding the outstanding balance constant).

Distribution of Assets, Liabilities and Shareholders' Equity

Interest Rates and Interest Differential – Tax Equivalent Basis

Table 1

	For the Years Ended December 31								
	2012			2011			2010		
(Dollars in thousands)	Average Balance	Interest	Average Yield/Rate	Average Balance	Interest	Average Yield/Rate	Average Balance	Interest	Average Yield/Rate
Assets									
Loans	$908,213	$46,742	5.15%	$953,774	$52,343	5.49%	$1,074,080	$61,115	5.69%
Investment Securities:									
Taxable	172,765	4,077	2.36	173,811	4,081	2.35	148,565	5,524	3.72
Non taxable	59,779	3,128	5.23	76,237	4,228	5.55	94,728	5,518	5.83
Total	232,544	7,205	3.1	250,048	8,309	3.32	243,293	11,042	4.54
Federal funds sold	58,645	138	0.24	109,287	265	0.24	190,878	422	0.22
Interest-bearing deposits with other banks	11,113	4	0.04	19,922	15	0.08	87,860	104	0.12
Other interest earning assets	9,762	167	1.71	11,797	97	0.82	13,453	47	0.35
Total earning assets	1,220,277	54,256	4.45%	1,344,828	61,029	4.54%	1,609,564	72,730	4.52%
Allowance for loan losses	(17,379)			(21,495)			(22,530)		
Non-earning assets	157,979			167,896			176,265		
Total Assets	$1,360,877			$1,491,229			$1,763,299		
Liabilities and Shareholders' Equity									
Interest-bearing demand deposits	$120,616	$180	0.15%	$98,395	$134	0.14%	$115,478	$387	0.34%
Interest-bearing money markets	203,497	424	0.21	224,303	748	0.33	286,639	2,418	0.84
Savings deposits	107,964	205	0.19	100,598	277	0.28	83,734	566	0.68
Time deposits:									
Less than $100k	214,613	2,696	1.26	290,651	5,650	1.94	366,922	7,802	2.13
$100k or more	198,051	3,054	1.54	267,648	5,090	1.9	388,945	6,910	1.78
Short-term borrowings	38,875	133	0.34	41,780	236	0.56	45,055	283	0.63
Long-term borrowings	198,541	7,273	3.66	217,112	9,071	4.18	252,889	10,798	4.27
Total interest-bearing liabilities	1,082,157	13,965	1.29%	1,240,487	21,206	1.71%	1,539,662	29,164	1.89%
Non-interest-bearing deposits	160,145			135,365			109,145		

Other liabilities	21,258			17,662			13,507		
Shareholders' Equity	97,317			97,715			100,985		
Total Liabilities and Shareholders' Equity	$1,360,877			$1,491,229			$1,763,299		
Net interest income and spread		$40,291	3.16%		$39,823	2.83%		$43,566	2.63%
Net interest margin			3.30%			2.96%			2.71%

Notes:

(1) The above table reflects the average rates earned or paid stated on a FTE basis assuming a tax rate of 35% for 2012, 2011 and 2010. The FTE adjustments for the years ended December 31, 2012, 2011 and 2010 were $1,145, $1,533 and $1,983, respectively.

(2) The average balances of non-accrual loans for the years ended December 31, 2012, 2011 and 2010, which were reported in the average loan balances for these years, were $29,208, $39,806 and $42,506, respectively.

(3) Net interest margin is calculated as net interest income divided by average earning assets.

(4) The average yields on investments are based on amortized cost.

Interest Variance Analysis (1)

Table 2

	2012 Compared to 2011			2011 Compared to 2010		
(In thousands and tax equivalent basis)	Volume	Rate	Net	Volume	Rate	Net
Interest Income:						
Loans	$(2,345)	$(3,256)	$(5,601)	$(6,605)	$(2,167)	$(8,772)
Taxable Investments	(25)	21	(4)	593	(2,036)	(1,443)
Non-taxable Investments	(861)	(239)	(1,100)	(1,026)	(264)	(1,290)
Federal funds sold	(119)	(8)	(127)	(196)	39	(157)
Other interest earning assets	(189)	248	59	(624)	586	(38)
Total interest income	(3,539)	(3,234)	(6,773)	(7,858)	(3,842)	(11,700)
Interest Expense:						
Interest-bearing demand deposits	33	13	46	(23)	(230)	(253)
Interest-bearing money markets	(43)	(281)	(324)	(206)	(1,465)	(1,671)
Savings deposits	14	(86)	(72)	47	(336)	(289)
Time deposits less than $100	(955)	(1,999)	(2,954)	(1,480)	(672)	(2,152)
Time deposits $100 or more	(1,073)	(963)	(2,036)	(2,305)	485	(1,820)
Short-term borrowings	(10)	(93)	(103)	(18)	(29)	(47)
Long-term borrowings	(680)	(1,118)	(1,798)	(1,495)	(232)	(1,727)
Total interest expense	(2,714)	(4,527)	(7,241)	(5,480)	(2,479)	(7,959)
Net interest income	$(825)	$1,293	$468	$(2,378)	$(1,363)	$(3,741)

Note:

(1) The change in interest income/expense due to both volume and rate has been allocated to volume and rate changes in proportion to the relationship of the absolute dollar amounts of the change in each.

Provision for Loan Losses

The provision for loan losses was $9.4 million for the year ended 2012, compared to $9.2 million for the year ended December 31, 2011. The higher provision expense was primarily due to the aforementioned $9.0 million charge-off of the shared national credit for an ethanol plant (included in C&I loans) during the first quarter of 2012. We also experienced a reduction in the level of classified assets (discussed below in the section entitled “FINANCIAL CONDITION” under the heading “Allowance and Provision for Loan Losses”). Management strives to ensure that the ALL reflects a level commensurate with the risk inherent in our loan portfolio.

Other Operating Income

The following table shows the major components of other operating income for the past two years, exclusive of net gains/(losses), and the percentage changes during these years:

(Dollars in thousands)	2012	2011	% Change
Service charges on deposit accounts	$2,851	$3,019	-5.56 %
Other service charge income	788	652	20.86 %
Debit card income	2,010	2,125	-5.41 %
Trust department income	4,608	4,413	4.42 %
Insurance commissions	11	2,424	-99.55 %
Bank owned life insurance (BOLI)	1,778	1,030	72.62 %
Brokerage commissions	778	767	1.43 %
Other income	806	536	50.37 %
Total other operating income	$13,630	$14,966	-8.93 %

Other operating income, exclusive of gains, decreased $1.3 million during 2012 when compared to 2011. Service charge income and debit card income both remained stable when comparing 2012 and 2011. Bank owned life insurance income increased due to the $.7 million one-time, tax free death benefit that occurred in March 2012. Insurance commissions decreased $2.4 million due to the sale of the assets of the Insurance Agency effective January 1, 2012. The sale did not have a material impact on our financial condition or results of operations. Other income increased $.3 million in 2012 when compared to 2011 offset by a slight decline of $.1 million in debit card income. Trust department income increased $.2 million when comparing 2012 to 2011. Trust assets under management were $637 million at December 31, 2012 and $595 million at December 31, 2011.

Net gains of $1.7 million were reported through other income during 2012, compared to net gains of $2.3 million during 2011. The decrease in net gains in 2012 was primarily attributable to an increase of $.7 million in net gains on sales of investment securities offset by the $1.4 million gain on the sale of indirect auto loans in 2011.

Other Operating Expense

The following table shows the major components of other operating expense for the past two years and the percentage changes during these years:

(Dollars in thousands)	2012	2011	% Change
Salaries and employee benefits	$19,481	$20,225	-3.68 %
Other expenses	7,061	7,426	-4.92 %
FDIC premiums	1,985	2,362	-15.96 %
Equipment	2,624	3,015	-12.97 %
Occupancy	2,719	2,804	-3.03 %
Data processing	2,886	2,744	5.17 %
Professional services	1,292	1,575	-17.97 %
Other real estate owned expense	890	2,410	-63.07 %
Miscellaneous loan fees	580	849	31.68 %
Total other operating expense	$39,518	$43,410	-8.97 %

Other operating expenses decreased $3.9 million (9.0%) for the year ended December 31, 2012 when compared to the year ended December 31, 2011. The decrease was due to a decline of $.7 million in salaries and benefits resulting primarily from a reduction of full-time equivalent employees as a result of the sale of the assets of the Insurance Agency on January 1, 2012. A decline of $.4 million in FDIC premiums attributable to the repayment of brokered deposits also impacted the reduced expenses. Other real estate expenses decreased $1.5 million in 2012 when compared to 2011 primarily due to a $.5 million decrease in write-downs, an increase of $.7 in gains on sales of properties and an increase in OREO rental income of $.3 million. A decrease of $.4 million in equipment expense was the result of reduced depreciation during 2012 when compared to 2011. Other miscellaneous expenses, such as legal and professional, marketing, consulting and postage, were also reduced when comparing 2012 to 2011 as management continued its vigilance in maintaining and reducing operating expenses.

Applicable Income Taxes

Due to improved operating results in 2012, we recognized a tax expense of $.9 million in 2012, compared to a net tax benefit of $.6 million in 2011. See Note 17 to the Consolidated Financial Statements under the heading “Income Taxes” for a detailed analysis of our deferred tax assets and liabilities. A valuation allowance has been provided for the $1.5 million in state tax loss carry forwards included in deferred tax assets, which will expire commencing in 2030.

At December 31, 2012 the Corporation has federal net operating losses (“NOL”) of approximately $10.0 million and West Virginia NOLs of approximately $5.3 million for which deferred tax assets of $3.5 million and $0.2 million, respectively, have been recorded at December 31, 2012. The federal and West Virginia NOLs were created in 2011 and 2010 and will begin expiring in 2030. Management has determined that a deferred tax valuation allowance is not required for 2012 on the Federal and West Virginia NOLs because we believe it is more likely than not that these deferred tax assets can be realized prior to expiration of their carry-forward period. This determination is based primarily on the ability of the Corporation to immediately generate approximately $13.4 million of taxable income through tax planning strategies, irrespective of any additional future operating income. At December 31, 2012 these strategies include the ability to generate approximately $4.1 million in taxable gains through the sale of investment securities, approximately $8.0 million in taxable gains through the sale of its Bank Owned Life Insurance and approximately $1.3 million in taxable gains through the sale of its fixed rate mortgage portfolio.

The Corporation has Maryland net operating loss carry-forwards of $28.4 million for the NOL of the Parent Company for which a deferred tax asset of $1.5 million has been recorded at December 31, 2012. There has been and continues to be a full valuation allowance on the Parent Company's NOL based on the fact that it is more likely than not that this deferred tax asset will not be realized because the Parent company files a separate tax return and has recurring tax losses and will not generate sufficient taxable income in the future to utilize them before they expire beginning in 2019. The valuation allowance of $1.5 million at December 31, 2012 reflects an increase of $.1 million from the level at December 31, 2011.

In addition, we have concluded that no valuation allowance is deemed necessary for the Corporation's remaining Federal and State deferred tax assets at December 31, 2012 as it is more likely than not (defined a level of likelihood that is more than 50 percent) that they will be realized based on the expected reversal of deferred tax liabilities, the generation of future income sufficient to realize the deferred tax assets as they reverse and the ability to implement tax planning strategies to prevent the expiration of any carry-forward periods. In making this determination, management considered the following:

- the expected reversal of all but $1.9 million of the total $3.4 million of deferred tax liabilities at December 31, 2012 in such a manner so as to substantially utilize the dollar for dollar impact against the deferred tax assets at December 31, 2012;
- for the remaining excess deferred tax assets that will not be utilized by the reversal of deferred tax liabilities, our expected future income will be sufficient to utilize the deferred tax assets as they reverse or before any net operating loss, if created, would expire; and
- tax planning strategies that can provide both one-time increases to taxable income of up to approximately $7.5 - $8.5 million and recurring annual decreases in unfavorable permanent items.

We will need to generate future taxable income of approximately $74 - $76 million to fully utilize the net deferred tax assets in the years in which they are expected to reverse. Management estimates that we can fully utilize the deferred tax assets in approximately seven years based on the historical pre-tax income and forecasts of estimated future pre-tax income as adjusted for permanent book to tax differences.

CONSOLIDATED BALANCE SHEET REVIEW

Overview

Our total assets were $1.32 billion at December 31, 2012, representing a decrease of $70.1 million (5.0%) from assets at December 31, 2011. The decrease resulted from a reduction in loan balances due to payback, charge-off and scheduled principal amortization and a strategic decision to continue to deploy excess cash to repay wholesale borrowings and brokered certificates of deposit and invest in investment securities during 2012.

The total interest-earning asset mix at December 31, 2012 remained consistent when compared to 2011. The mix for each year is illustrated below:

	Year End Percentage of Total Assets			
	2012		2011	
Cash and cash equivalents	6	%	5	%
Net loans	65	%	66	%
Investments	17	%	18	%

[37]

The year-end total liability mix has remained consistent during the two-year period as illustrated below.

	Year End Percentage of Total Liabilities			
	2012		2011	
Total deposits	80	%	79	%
Total borrowings	18	%	19	%

Loan Portfolio

The Bank is actively engaged in originating loans to customers primarily in Allegany County, Frederick County, Garrett County, and Washington County in Maryland, and in Berkeley County, Hardy County, Mineral County, and Monongalia County in West Virginia; and the surrounding regions of West Virginia and Pennsylvania. We have policies and procedures designed to mitigate credit risk and to maintain the quality of our loan portfolio. These policies include underwriting standards for new credits as well as continuous monitoring and reporting policies for asset quality and the adequacy of the allowance for loan losses. These policies, coupled with ongoing training efforts, have provided effective checks and balances for the risk associated with the lending process. Lending authority is based on the type of the loan, and the experience of the lending officer.

Commercial loans are collateralized primarily by real estate and, to a lesser extent, equipment and vehicles. Unsecured commercial loans represent an insignificant portion of total commercial loans. Residential mortgage loans are collateralized by the related property. Generally, a residential mortgage loan exceeding a specified internal loan-to-value ratio requires private mortgage insurance. Installment loans are typically collateralized, with loan-to-value ratios which are established based on the financial condition of the borrower. We will also make unsecured consumer loans to qualified borrowers meeting our underwriting standards. Additional information about our loans and underwriting policies can be found in Item 1 of Part I of this annual report under the heading “Banking Products and Services”.

Table 3 sets forth the composition of our loan portfolio. Historically, our policy has been to make the majority of our loan commitments in our market areas. We had no foreign loans in our portfolio as of December 31 for any of the years presented.

Summary of Loan Portfolio

Table 3

The following table presents the composition of our loan portfolio for the past five years:

(In millions)	2012	2011	2010	2009	2008
Commercial real estate	$298.8	$336.2	$348.6	$326.8	$322.4
Acquisition and development	128.4	142.9	156.9	231.7	227.0
Commercial and industrial	69.0	78.7	70.0	81.3	77.7
Residential mortgage	346.9	347.2	356.7	373.2	382.0
Consumer	31.7	33.7	77.6	108.9	125.4
Total Loans	$874.8	$938.7	$1,009.8	$1,121.9	$1,134.5

Comparing December 31, 2012 to December 31, 2011, outstanding loans decreased by $63.9 million (6.8%). CRE loans decreased $37.4 million as a result of payoffs of several large loans, charge-offs of loan balances and ongoing scheduled principal payments. C&I loans decreased $9.7 million due to the single $9.0 million charge-off during the year, and residential mortgages declined $.3 million. A&D loans decreased $14.5 million due to principal repayments and charge offs. The residential mortgage portfolio remained stable as new production offset regularly scheduled principal payments on and refinancings of existing loans and due to management's decision to use secondary market outlets such as Fannie Mae for the majority of new, longer-term, fixed-rate residential loan originations. The consumer loan portfolio declined $2.0 million due to repayment activity in the indirect auto portfolio which exceeded new production due to special financing offered by the automotive manufacturers, credit unions and certain large regional banks and management's decision to de-emphasize this line of business.

At December 31, 2012, approximately 60% of the commercial loan portfolio was collateralized by real estate, compared to approximately 64% at December 31, 2011.

At December 31, 2012, adjustable interest rate loans made up 64% of total loans, compared to 63% at December 31, 2011. Fixed–interest rate loans made up 36% of the total loan portfolio at December 31, 2012, compared to 37% of total loans at December 31, 2011.

Comparing December 31, 2011 to December 31, 2010, outstanding loans decreased by $38.6 million (3.8%), net of the sale of $32.5 million of the indirect auto portfolio. CRE loans decreased $12.4 million as a result of the payoff of several large loans, charge-offs of loan balances and ongoing scheduled principal payments. C&I loans increased $8.7 million and residential mortgages declined $9.5 million. A&D loans decreased $14.0 million due primarily to principal repayments and charge offs. The decrease in the residential mortgage portfolio was attributable to regularly scheduled principal payments on existing loans and management's decision to use secondary market outlets such as Fannie Mae for the majority of new, longer-term, fixed-rate residential loan originations. The consumer portfolio declined $43.9 million due primarily to the sale of $32.5 million of retail installment contracts in our indirect auto loan portfolio and $11.4 million of repayment activity in the indirect auto portfolio exceeded new production due to special financing offered by the automotive manufacturers, credit unions and certain large regional banks. At December 31, 2011, approximately 64% of the commercial loan portfolio was collateralized by real estate, compared to approximately 71% at December 31, 2010.

The following table sets forth the maturities, based upon contractual dates, for selected loan categories as of December 31, 2012:

Maturities of Loan Portfolio at December 31, 2012

Table 4

(In thousands)	Maturing Within One Year	Maturing After One Year But Within Five Years	Maturing After Five Years	Total
Commercial Real Estate	$26,606	$61,644	$210,601	$298,851
Acquisition and Development	37,549	31,520	59,322	128,391
Commercial and Industrial	14,056	22,409	32,548	69,013
Residential Mortgage	14,899	6,432	325,588	346,919

Consumer	8,826	19,347	3,482	31,655
Total Loans	$101,936	$141,352	$631,541	$874,829
Classified by Sensitivity to Change in Interest Rates				
Fixed-Interest Rate Loans	39,922	98,860	174,803	313,585
Adjustable-Interest Rate Loans	62,014	42,492	456,738	561,244
Total Loans	$101,936	$141,352	$631,541	$874,829

Management monitors the performance and credit quality of the loan portfolio by analyzing the age of the portfolio as determined by the length of time a recorded payment is past due. A loan is considered to be past due when a payment has not been received for 30 days past its contractual due date. For all loan segments, the accrual of interest is discontinued when principal or interest is delinquent for 90 days or more unless the loan is well-secured and in the process of collection. All non-accrual loans are considered to be impaired. Interest payments received on non-accrual loans are applied as a reduction of the loan principal balance. Loans are returned to accrual status when all principal and interest amounts contractually due are brought current and future payments are reasonably assured. Our policy for recognizing interest income on impaired loans does not differ from our overall policy for interest recognition.

Table 5 sets forth the amounts of non-accrual, past-due and restructured loans for the past five years:

Risk Elements of Loan Portfolio

Table 5

	At December 31,				
(In thousands)	2012	2011	2010	2009	2008
Non-accrual loans:					
Commercial real estate	$6,194	$10,069	$11,893	$4,046	$2,175
Acquisition and development	10,778	14,938	16,269	37,244	16,520
Commercial and industrial	176	9,364	1,355	0	2,338
Residential mortgage	2,731	3,796	5,236	5,227	3,434
Consumer	36	21	152	67	86
Total non-accrual loans	$19,915	$38,188	$34,905	$46,584	$24,553
Accruing Loans Past Due 90 days or more:					
Commercial real estate	$0	$0	$0	$0	$513
Acquisition and development	200	128	128	0	430
Commercial and industrial	0	0	44	0	174
Residential mortgage	1,888	1,509	2,437	1,483	1,686
Consumer	58	142	183	287	673
Total accruing loans past due 90 days or more	$2,146	$1,779	$2,792	$1,770	$3,476
	$22,061	$39,967	$37,697	$48,354	$28,029
Restructured Loans (TDRs):					
Performing	$12,134	$10,657	$5,506	$22,160	$349
Non-accrual (included above)	5,540	7,385	9,593	13,321	119
Total TDRs	$17,674	$18,042	$15,099	$35,481	$468
Other Real Estate Owned	$17,513	$16,676	$18,072	$7,591	$2,424
Impaired loans without a valuation allowance	$39,361	$41,778	$42,890	$102,553	$66,816
Impaired loans with a valuation allowance	8,481	20,048	19,713	28,677	16,519
Total impaired loans	$47,842	$61,826	$62,603	$131,230	$83,335
Valuation allowance related to impaired loans	$1,632	$3,951	$4,366	$7,624	$4,759

Non-Accrual Loans as a % of Applicable Portfolio

	2012	2011	2010	2009	2008
Commercial real estate	2.1 %	3.0 %	3.4 %	1.2 %	0.7 %
Acquisition and development	8.4 %	10.5%	10.4%	16.1%	7.3 %
Commercial and industrial	0.3 %	11.9%	1.9 %	0.0 %	3.0 %
Residential mortgage	0.8 %	1.1 %	1.5 %	1.4 %	0.9 %
Consumer	0.1 %	0.1 %	0.2 %	0.1 %	0.1 %

[40]

Interest income not recognized as a result of placing loans on non-accrual status was $1.7 million for the year ended December 31, 2012, and there was $94,000 of interest income recognized on a cash basis during 2012.

Performing loans considered to be impaired (including performing troubled debt restructurings, or TDRs), as defined and identified by management, amounted to $28.2 million at December 31, 2012 and $23.6 million at December 31, 2011. Loans are identified as impaired when, based on current information and events, management determines that we will be unable to collect all amounts due according to contractual terms. These loans consist primarily of A&D loans and CRE loans. The fair values are generally determined based upon independent third party appraisals of the collateral or discounted cash flows based upon the expected proceeds. Specific allocations have been made where management believes there is insufficient collateral to repay the loan balance if liquidated and there is no secondary source of repayment available.

The level of performing impaired loans (other than performing TDRs) increased $3.1 million during the year ended December 31, 2012, due to the addition of $4.8 million of loans added to performing accrued status, partially offset by $1.7 million of net principal repayments received in the year. The new performing impaired balances were related to two relationships. Management will continue to monitor all loans that have been removed from an impaired status and take appropriate steps to ensure that satisfactory performance is sustained.

The following table presents the details of TDRs by loan class at December 31, 2012 and December 31, 2011:

(in thousands)	December 31, 2012 Number of Contracts	Recorded Investment	December 31, 2011 Number of Contracts	Recorded Investment
Performing				
Commercial real estate				
Non owner-occupied	2	$ 273	2	$ 287
All other CRE	5	5,676	1	3,162
Acquisition and development				
1-4 family residential construction	1	2,052	1	2,489
All other A&D	4	2,330	4	2,645
Commercial and industrial	2	557	1	693
Residential mortgage				
Residential mortgage – term	4	1,246	5	1,381
Residential mortgage – home equity	0	0	0	0
Consumer	0	0	0	0
Total performing	18	$ 12,134	14	$ 10,657
Non-accrual				
Commercial real estate				
Non owner-occupied	1	$ 448	1	$ 448

All other CRE	0	0	0	0
Acquisition and development				
1-4 family residential construction	0	0	0	0
All other A&D	6	4,600	7	6,719
Commercial and industrial	0	0	0	0
Residential mortgage				
Residential mortgage – term	2	492	1	218
Residential mortgage – home equity	0	0	0	0
Consumer	0	0	0	0
Total non-accrual	9	5,540	9	7,385
Total TDRs	27	$ 17,674	23	$ 18,042

[41]

The level of TDRs decreased $.4 million during 2012, reflecting the addition of eight loans totaling $3.9 million to performing TDRs and one loan totaling $.3 million to non-accrual TDRs, as well as the re-modification of five loans totaling $7.6 million already in performing TDRs. Principal payments of $1.3 million on performing TDRs and $2.0 million on non-performing TDRs were received in 2012. Additionally, $.8 million of performing TDRs and a $.2 non-performing TDR were paid-off during 2012. Three loans totaling $.3 million that had been modified at market rates prior to December 31, 2011 were removed from performing TDRs during 2012 because the borrowers had made at least six consecutive payments and were current at the time of reclassification.

At December 31, 2012, additional funds of up to $2.1 million were committed to be advanced in connection with TDRs. Interest income not recognized due to rate modifications of TDRs was $.1 million, and interest income recognized on all TDRs was $.6 million in 2012.

Allowance for Loan Losses

The ALL is maintained to absorb losses from the loan portfolio. The ALL is based on management’s continuing evaluation of the quality of the loan portfolio, assessment of current economic conditions, diversification and size of the portfolio, adequacy of collateral, past and anticipated loss experience, and the amount of non-performing loans.

The ALL is also based on estimates, and actual losses will vary from current estimates. These estimates are reviewed quarterly, and as adjustments, either positive or negative, become necessary, a corresponding increase or decrease is made in the ALL. The methodology used to determine the adequacy of the ALL is consistent with prior years. An estimate for probable losses related to unfunded lending commitments, such as letters of credit and binding but unfunded loan commitments is also prepared. This estimate is computed in a manner similar to the methodology described above, adjusted for the probability of actually funding the commitment.

The ALL decreased to $16.0 million at December 31, 2012, compared to $19.5 million at December 31, 2011. The provision for loan losses for the year ended December 31, 2012 increased to $9.4 million from $9.2 million for the year ended December 31, 2011. Net charge-offs rose to $12.8 million for the year ended December 31, 2012, compared to $11.8 million for the year ended December 31, 2011. Included in the net charge-offs for the year ended December 31, 2012 were the aforementioned $9.0 million charge-off on a shared national credit for an ethanol plant, a $1.1 million charge-off for a participation loan, and a $.9 million charge-off for a non owner-occupied commercial real estate loan. The increased provision expense was primarily due to these three large charge-offs. The ratio of the ALL to loans outstanding as of December 31, 2012 was 1.83%, which was lower than the 2.08% at December 31, 2011 due to the charge-off or removal of specific allocations as a result of changing circumstances.

The ratio of net charge-offs to average loans for the year ended December 31, 2012 was 1.41%, compared to 1.24% for the year ended December 31, 2011. Relative to December 31, 2011, all segments of loans, with the exception of C&I and residential mortgage loans, showed improvement. The net charge-off ratio for CRE loans as of December 31, 2012 was .67%, compared to 2.02% as of December 31, 2011. The net charge-off ratio for A&D loans as of December 31, 2012 was .29%, compared to 1.91% as of December 31, 2011. The ratios for C&I loans were 12.1% and .99% for December 31, 2012 and December 31, 2011, respectively, as a result of the $9.0 million full charge-off described above. The residential mortgage ratios were .33% and .32% for December 31, 2012 and December 31, 2011, respectively, and the consumer loan ratios were .69% and 1.17%, for December 31, 2012 and December 31, 2011, respectively. Without the $9.0 million C&I charge-off, the ratio of net charge-offs to average loans in 2012 would have been .41% and a net recovery rate of .18% for C&I loans.

Accruing loans past due 30 days or more declined to 2.39% of the loan portfolio at December 31, 2012, compared to 2.86% at December 31, 2011. The decrease for 2012 was primarily due to the full payoff of two past due CRE loans totaling $5.2 million in 2012. Other improvements in the levels of past-due loans were attributable to a combination of a slowly improving economy and vigorous collection efforts by the Bank.

Non-accrual loans totaled $19.9 million as of December 31, 2012, compared to $38.2 million as of December 31, 2011. The $18.3 million decline in non-accrual loans was due primarily to the $9.0 million C&I charge-off as well as the payoff of one $4.4 million CRE loan and payoffs/pay downs of $7.4 million on three A&D loans during 2012. Non-accrual loans which have been subject to a partial charge-off totaled $6.7 million as of December 31, 2012, compared to $13.4 million as of December 31, 2011.

Management believes that the ALL at December 31, 2012 is adequate to provide for probable losses inherent in our loan portfolio. Amounts that will be recorded for the provision for loan losses in future periods will depend upon trends in the loan balances, including the composition of the loan portfolio, changes in loan quality and loss experience trends, potential recoveries on previously charged-off loans and changes in other qualitative factors. Management also applies interest rate risk, collateral value and debt service sensitivity analyses to the CRE loan portfolio and obtains new appraisals on specific loans under defined parameters to assist in the determination of the periodic provision for loan losses.

The ALL decreased to $19.5 million at December 31, 2011 from $22.1 million at December 31, 2010. The provision for loan losses for the year ended December 31, 2011 decreased to $9.2 million from $15.7 million for the year ended December 31, 2010. Net charge-offs declined to $11.8 million at December 31, 2011 from $13.7 million at December 31, 2010. Included in the net charge-offs for the year ended December 31, 2011 were partial charge-offs of $5.1 million for two large CRE loans and $1.5 million for one other A&D loan. The decrease in the provision for loan losses from 2010 to 2011 resulted from management's analysis of the adequacy of the loan loss reserve, declining loan balances, charge-offs and improving economic conditions as noted by the Federal Reserve. The sale of $32.5 million of the indirect auto portfolio, which released $.6 million in provision expense, was a contributing factor to the lower provision expense. The ratio of the ALL to loans outstanding as of December 31, 2011 was 2.08%, compared to 2.19% as of December 31, 2010. The decrease was due to a focused effort by management to recognize potential problem loans, charge-off potentially uncollectible balances, and record specific allocations and adjust qualitative factors to reflect the current quality of the loan portfolio.

Table 6 presents the activity in the allowance for loan losses by major loan category for the past five years.

Analysis of Activity in the Allowance for Loan Losses

Table 6

	For the Years Ended December 31,				
(In thousands)	2012	2011	2010	2009	2008
Balance, January 1	$19,480	$22,138	$20,090	$14,347	$7,304
Charge-offs:					
Commercial real estate	(2,289)	(6,886)	(543)	(729)	(109)
Acquisition and development	(809)	(3,055)	(9,770)	(3,902)	(838)
Commercial and industrial	(9,402)	(840)	(2,225)	(2,246)	(2,951)
Residential mortgage	(1,314)	(1,664)	(2,008)	(1,495)	(672)
Consumer	(650)	(893)	(1,791)	(2,413)	(2,025)
Total charge-offs	(14,464)	(13,338)	(16,337)	(10,785)	(6,595)
Recoveries:					
Commercial real estate	156	95	94	103	0
Acquisition and development	420	322	1,097	40	23

Commercial and industrial	464	57	538	201	33
Residential mortgage	177	550	391	80	120
Consumer	424	499	539	516	537
Total recoveries	1,641	1,523	2,659	940	713
Net credit losses	(12,823)	(11,815)	(13,678)	(9,845)	(5,882)
Provision for loan losses	9,390	9,157	15,726	15,588	12,925
Balance at end of period	$16,047	$19,480	$22,138	$20,090	$14,347
Allowance for loan losses to loans outstanding (as %)	1.83 %	2.08 %	2.19 %	1.79 %	1.26 %
Net charge-offs to average loans outstanding during the period (as %)	1.41 %	1.24 %	1.28 %	0.87 %	0.54 %

Table 7 presents management's allocation of the ALL by major loan category in comparison to that loan category's percentage of total loans. Changes in the allocation over time reflect changes in the composition of the loan portfolio risk profile and refinements to the methodology of determining the ALL. Specific allocations in any particular category may be reallocated in the future as needed to reflect current conditions. Accordingly, the entire ALL is considered available to absorb losses in any category.

Allocation of the Allowance for Loan Losses

Table 7

	For the Years Ended December 31,									
(In thousands)	2012	% of Total Loans	2011	% of Total Loans	2010	% of Total Loans	2009	% of Total Loans	2008	% of Total Loans
Commercial real estate	$5,206	34 %	$6,218	36 %	$8,658	35 %	$5,351	29 %	$3,289	28 %
Acquisition and development	5,029	15 %	7,190	15 %	6,345	16 %	7,922	21 %	3,396	20 %
Commercial and industrial	906	8 %	2,190	8 %	1,345	7 %	1,945	7 %	2,318	7 %
Residential mortgage	4,507	39 %	3,430	37 %	4,211	35 %	3,061	33 %	3,437	34 %
Consumer	399	4 %	452	4 %	1,579	7 %	1,811	10 %	1,907	11 %
Total	$16,047	100 %	$19,480	100 %	$22,138	100 %	$20,090	100 %	$14,347	100 %

Investment Securities

The following table sets forth the composition of our securities portfolio by major category as of the indicated dates:

Table 8

	At December 31,								
	2012			2011			2010		
(In thousands)	Amortized Cost	Fair Value (FV)	FV As % of Total	Amortized Cost	Fair Value (FV)	FV As % of Total	Amortized Cost	Fair Value (FV)	FV AS % of Total
Securities Available-for-Sale:									
U.S. government agencies	$40,334	$40,320	18 %	$25,490	$25,580	11 %	$24,813	$24,850	11 %
Residential mortgage- backed agencies	43,596	44,108	20 %	43,630	44,552	18 %	53,424	54,317	24 %
Commercial mortgage-backed agencies	37,330	37,618	17 %	48,112	48,277	19 %	0	0	0
Collateralized mortgage									

obligations	31,836	31,731	14	%	48,120	48,351	20	%	45,448	45,958	20	%
Obligations of states and political subdivisions	55,212	58,054	26	%	65,424	68,816	28	%	94,250	94,724	41	%
Collateralized debt obligations	36,798	11,442	5	%	36,385	9,447	4	%	36,533	9,838	4	%
Total available for sale	$245,106	$223,273	100	%	$267,161	$245,023	100	%	$254,468	$229,687	100	%
Securities Held to Maturity:												
Obligations of states and political subdivisions	$4,040	$4,347	100	%	$0	$0	0	%	$0	$0	0	%

Total investment securities decreased $17.4 million during 2012 when compared to the balance at December 31, 2011. At December 31, 2012, the securities classified as available-for-sale included a net unrealized loss of $21.8 million, which represents the difference between the fair value and amortized cost of securities in the portfolio and is primarily attributable to the collateralized debt obligations (“CDOs”). Two tax increment fund bonds were moved to held to maturity during the first quarter of 2012 reflecting management’s intent to hold the securities until the earlier of their full repayment or maturity.

As discussed in Note 24 to the Consolidated Financial Statements, we measure fair market values based on the fair value hierarchy established in ASC Topic 820, *Fair Value Measurements and Disclosures*. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). Level 3 prices or valuation techniques require inputs that are both significant to the valuation assumptions and are not readily observable in the market (i.e. supported with little or no market activity). These Level 3 instruments are valued based on both observable and unobservable inputs derived from the best available data, some of which is internally developed, and considers risk premiums that a market participant would require.

Approximately $211.8 million of the available-for-sale portfolio was valued using Level 2 pricing and had net unrealized gains of $3.5 million at December 31, 2012. The remaining $11.4 million of the securities available-for-sale represents the entire CDO portfolio, which was valued using significant unobservable inputs, or Level 3 pricing. The $25.4 million in unrealized losses associated with this portfolio relates to 18 pooled trust preferred securities that comprise the CDO portfolio. Unrealized losses of $16.9 million represent non-credit related OTTI charges on 13 of the securities, while $8.5 million of unrealized losses relates to five securities which have no credit related OTTI. The unrealized losses on these securities are primarily attributable to continued depression in the marketability and liquidity associated with CDOs.

The following table provides a summary of the trust preferred securities in the CDO portfolio and the credit status of the securities as of December 31, 2012.

Level 3 Investment Securities Available for Sale

(Dollars in Thousands)

Investment Description		**First United Level 3 Investments**				**Security Credit Status**					
Deal	**Class**	**Amortized Cost**	**Fair Market Value**	**Unrealized Gain (Loss)**	**Lowest Credit Rating**	**Original Collateral**	**Deferrals/ Defaults as % of Original Collateral**	**Performing Collateral**	**Collateral Support**	**Collateral Support as % of Performing Collateral**	**Number of Performing Issuers/Total Issuers**
Preferred Term Security I	Mezz	672	511	(161)	C	303,112	19.46%	118,000	(13,122)	-11.12%	13 / 17
Preferred Term Security XI*	B-1	1,350	420	(930)	C	635,775	28.67%	391,105	(117,044)	-29.93%	42 / 62
Preferred Term Security XVI*	C	237	209	(28)	C	606,040	40.86%	324,060	(161,209)	-49.75%	34 / 56
Preferred Term Security XVIII	C	2,115	493	(1,622)	C	676,565	28.57%	466,479	(97,549)	-20.91%	49 / 75
Preferred Term	C	3,033	740	(2,293)	C	676,565	28.57%	466,479	(97,549)	-20.91%	49 / 75

Security XVIII*											
Preferred Term Security XIX*	C	3,041	530	(2,511)	C	700,535	23.86%	472,731	(135,846)	-28.74%	46 / 66
Preferred Term Security XIX*	C	1,316	227	(1,089)	C	700,535	23.86%	472,731	(135,846)	-28.74%	46 / 66
Preferred Term Security XIX*	C	1,318	227	(1,091)	C	700,535	23.86%	472,731	(135,846)	-28.74%	46 / 66
Preferred Term Security XIX*	C	2,210	380	(1,830)	C	700,535	23.86%	472,731	(135,846)	-28.74%	46 / 66
Preferred Term Security XXII*	C-1	1,585	470	(1,115)	C	1,386,600	26.54%	913,600	(162,436)	-17.78%	60 / 91
Preferred Term Security XXII*	C-1	3,963	1,175	(2,788)	C	1,386,600	26.54%	913,600	(162,436)	-17.78%	60 / 91
Preferred Term Security XXIII*	C-1	2,082	646	(1,436)	C	1,467,000					