

FIDELITY D & D BANCORP INC  
Form 10-Q  
August 13, 2013  
UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2013

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number: 333-90273

FIDELITY D & D BANCORP, INC.

STATE OF INCORPORATION: IRS EMPLOYER IDENTIFICATION NO:

PENNSYLVANIA

23-3017653

Address of principal executive offices:

BLAKELY & DRINKER ST.

DUNMORE, PENNSYLVANIA 18512

TELEPHONE:

570-342-8281

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

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

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

YES  NO

The number of outstanding shares of Common Stock of Fidelity D & D Bancorp, Inc. on July 31, 2013, the latest practicable date, was 2,356,829 shares.

---

FIDELITY D & D BANCORP, INC.

Form 10-Q June 30, 2013

Index

|   | Page |
|---|------|
| Part I. Financial Information                                       |      |
| Item 1. Financial Statements (unaudited):                           |      |
| Consolidated Balance Sheets as of June 30, 2013                     |      |
| and December 31, 2012   | 3    |
| Consolidated Statements of Income for the three- and six-months     |      |
| ended June 30, 2013 and 2012  | 4    |
| Consolidated Statements of Comprehensive Income                     |      |
| for the three- and six-months ended June 30, 2013 and 2012          | 5    |
| Consolidated Statements of Changes in Shareholders' Equity          |      |
| for the six months ended June 30, 2013 and 2012                     | 6    |
| Consolidated Statements of Cash Flows for the six months            |      |
| ended June 30, 2013 and 2012  | 7    |
| Notes to Consolidated Financial Statements (Unaudited)              | 8    |
| Item 2. Management's Discussion and Analysis of Financial Condition |      |
| and Results of Operations   | 30   |
| Item 3. Quantitative and Qualitative Disclosure about Market Risk   | 46   |
| Item 4. Controls and Procedures                                     | 51   |
| Part II. Other Information  |      |
| Item 1. Legal Proceedings   | 51   |
| Item 1A. Risk Factors   | 51   |
| Item 2. Unregistered Sales of Equity Securities and Use of Proceeds | 51   |
| Item 3. Defaults upon Senior Securities                             | 51   |
| Item 4. Mine Safety Disclosures                                     | 51   |
| Item 5. Other Information   | 51   |
| Item 6. Exhibits  | 51   |
| Signatures  | 53   |
| Exhibit index   | 54   |



## PART I – Financial Information

## Item 1: Financial Statements

Fidelity D & D Bancorp, Inc. and Subsidiary  
Consolidated Balance Sheets  
(Unaudited)

| (dollars in thousands)   | June 30,<br>2013 | December<br>31, 2012 |
|--|------------------|----------------------|
| Assets:  |                  |                      |
| Cash and due from banks  | \$ 15,238        | \$ 12,657            |
| Interest-bearing deposits with financial institutions                                    | 28               | 9,189                |
| <br>Total cash and cash equivalents  | <br>15,266       | <br>21,846           |
| Available-for-sale securities  | 96,259           | 100,441              |
| Held-to-maturity securities  | 207              | 289                  |
| Federal Home Loan Bank stock   | 3,214            | 2,624                |
| Loans and leases, net (allowance for loan losses of<br>\$8,296 in 2013; \$8,972 in 2012) | 451,665          | 424,584              |
| Loans held-for-sale (fair value \$5,417 in 2013, \$10,824 in 2012)                       | 5,389            | 10,545               |
| Foreclosed assets held-for-sale  | 2,617            | 1,607                |
| Bank premises and equipment, net   | 13,802           | 14,127               |
| Cash surrender value of bank owned life insurance  | 10,231           | 10,065               |
| Accrued interest receivable  | 2,073            | 1,985                |
| Other assets   | 14,452           | 13,412               |
| <br>Total assets   | <br>\$ 615,175   | <br>\$ 601,525       |
| Liabilities:   |                  |                      |
| Deposits:  |                  |                      |
| Interest-bearing   | \$ 392,255       | \$ 388,625           |
| Non-interest-bearing   | 127,268          | 126,035              |
| <br>Total deposits   | <br>519,523      | <br>514,660          |
| Accrued interest payable and other liabilities   | 3,550            | 3,863                |
| Short-term borrowings  | 16,199           | 8,056                |
| Long-term debt   | 16,000           | 16,000               |
| <br>Total liabilities  | <br>555,272      | <br>542,579          |
| Shareholders' equity:  |                  |                      |
| Preferred stock authorized 5,000,000 shares with no par<br>value; none issued            | -                | -                    |

Edgar Filing: FIDELITY D & D BANCORP INC - Form 10-Q

|   |            |            |
|---|------------|------------|
| Capital stock, no par value (10,000,000 shares authorized;<br>shares issued and outstanding; 2,356,829 in 2013; and<br>2,323,248 in 2012) | 24,454     | 23,711     |
| Retained earnings   | 36,732     | 34,999     |
| Accumulated other comprehensive (loss) income   | (1,283)    | 236        |
| Total shareholders' equity  | 59,903     | 58,946     |
| Total liabilities and shareholders' equity  | \$ 615,175 | \$ 601,525 |

See notes to unaudited consolidated financial statements

2

---

Fidelity D & D Bancorp, Inc. and Subsidiary  
Consolidated Statements of Income

| (Unaudited)  | Three months<br>ended |                  | Six months ended |                  |
|--|-----------------------|------------------|------------------|------------------|
| (dollars in thousands except per share data)   | June 30,<br>2013      | June 30,<br>2012 | June 30,<br>2013 | June 30,<br>2012 |
| Interest income:   |                       |                  |                  |                  |
| Loans and leases:  |                       |                  |                  |                  |
| Taxable  | \$ 5,335              | \$ 5,292         | \$ 10,705        | \$ 10,572        |
| Nontaxable   | 121                   | 116              | 220              | 252              |
| Interest-bearing deposits with financial institutions  | 2                     | 15               | 14               | 43               |
| Investment securities:   |                       |                  |                  |                  |
| U.S. government agency and corporations  | 137                   | 240              | 316              | 521              |
| States and political subdivisions (nontaxable)   | 299                   | 310              | 589              | 619              |
| Other securities   | 18                    | 18               | 36               | 36               |
| Total interest income  | 5,912                 | 5,991            | 11,880           | 12,043           |
| Interest expense:  |                       |                  |                  |                  |
| Deposits   | 511                   | 617              | 1,026            | 1,301            |
| Securities sold under repurchase agreements  | 4                     | 8                | 13               | 23               |
| Other short-term borrowings and other  | 4                     | -                | 5                | -                |
| Long-term debt   | 213                   | 213              | 423              | 452              |
| Total interest expense   | 732                   | 838              | 1,467            | 1,776            |
| Net interest income  | 5,180                 | 5,153            | 10,413           | 10,267           |
| Provision for loan losses  | 600                   | 600              | 1,150            | 1,300            |
| Net interest income after provision for loan losses  | 4,580                 | 4,553            | 9,263            | 8,967            |
| Other income:  |                       |                  |                  |                  |
| Service charges on deposit accounts  | 459                   | 424              | 911              | 843              |
| Interchange fees   | 307                   | 268              | 580              | 522              |
| Fees from trust fiduciary activities   | 192                   | 149              | 340              | 307              |
| Fees from financial services   | 140                   | 118              | 296              | 286              |
| Service charges on loans   | 348                   | 357              | 582              | 651              |
| Fees and other revenue   | 119                   | 97               | 221              | 169              |
| Earnings on bank-owned life insurance  | 86                    | 81               | 166              | 161              |
| Gain (loss) on sale, recovery, or disposal of:   |                       |                  |                  |                  |
| Loans  | 390                   | 434              | 894              | 829              |
| Investment securities  | 9                     | 7                | 128              | 261              |
| Premises and equipment   | 1                     | (1)              | 1                | (1)              |
| Impairment losses on investment securities:  |                       |                  |                  |                  |
| Other-than-temporary impairment on investment securities   | -                     | (31)             | (61)             | (241)            |
| Non-credit-related losses on investment securities not expected to be sold (recognized in other comprehensive income (loss)) | -                     | -                | 61               | 105              |
| Net impairment losses on investment securities   | -                     | (31)             | -                | (136)            |
| Total other income   | 2,051                 | 1,903            | 4,119            | 3,892            |
| Other expenses:  |                       |                  |                  |                  |
| Salaries and employee benefits   | 2,422                 | 2,294            | 4,896            | 4,651            |



Edgar Filing: FIDELITY D & D BANCORP INC - Form 10-Q

|                             |          |          |          |          |
|-----------------------------|----------|----------|----------|----------|
| Premises and equipment      | 805      | 806      | 1,660    | 1,704    |
| Advertising and marketing   | 215      | 243      | 467      | 395      |
| Professional services       | 328      | 365      | 577      | 671      |
| FDIC assessment             | 123      | 127      | 249      | 249      |
| Loan collection             | 168      | 180      | 363      | 301      |
| Other real estate owned     | 61       | 104      | 184      | 159      |
| Office supplies and postage | 114      | 93       | 216      | 212      |
| Other                       | 370      | 497      | 875      | 1,118    |
| Total other expenses        | 4,606    | 4,709    | 9,487    | 9,460    |
| Income before income taxes  | 2,025    | 1,747    | 3,895    | 3,399    |
| Provision for income taxes  | 512      | 430      | 988      | 825      |
| Net income                  | \$ 1,513 | \$ 1,317 | \$ 2,907 | \$ 2,574 |
| Per share data:             |          |          |          |          |
| Net income - basic          | \$ 0.64  | \$ 0.57  | \$ 1.24  | \$ 1.13  |
| Net income - diluted        | \$ 0.64  | \$ 0.57  | \$ 1.24  | \$ 1.13  |
| Dividends                   | \$ 0.25  | \$ 0.25  | \$ 0.50  | \$ 0.50  |

See notes to unaudited consolidated financial statements

3

| Fidelity D & D Bancorp, Inc. and Subsidiary   |              |          |            |          |
|---|--------------|----------|------------|----------|
| Consolidated Statements of Comprehensive Income                                     | Three months |          | Six months |          |
| (Unaudited)   | ended        |          | ended      |          |
| (dollars in thousands)  | June 30,     |          | June 30,   |          |
|   | 2013         | 2012     | 2013       | 2012     |
| Net income  | \$ 1,513     | \$ 1,317 | \$ 2,907   | \$ 2,574 |
| Other comprehensive (loss) income, before tax:                                      |              |          |            |          |
| Unrealized holding (loss) gain on available-for-sale securities                     | (1,810)      | 514      | (2,227)    | 1,013    |
| Reclassification adjustment for net gains realized in income                        | (9)          | (7)      | (128)      | (261)    |
| Net impairment losses on investment securities                                      | -            | 31       | -          | 136      |
| Net unrealized (loss) gain  | (1,819)      | 538      | (2,355)    | 888      |
| Tax effect  | 619          | (183)    | 801        | (302)    |
| Unrealized (loss) gain, net of tax  | (1,200)      | 355      | (1,554)    | 586      |
| Non-credit-related impairment gain on investment securities not expected to be sold | 92           | 238      | 53         | 282      |
| Tax effect  | (31)         | (81)     | (18)       | (96)     |
| Net non-credit-related impairment gain on investment securities                     | 61           | 157      | 35         | 186      |
| Other comprehensive (loss) income, net of tax                                       | (1,139)      | 512      | (1,519)    | 772      |
| Total comprehensive income, net of tax  | \$ 374       | \$ 1,829 | \$ 1,388   | \$ 3,346 |

See notes to unaudited consolidated financial statements

Fidelity D & D Bancorp, Inc. and Subsidiary  
 Consolidated Statements of Changes in Shareholders' Equity  
 For the six months ended June 30, 2013 and 2012  
 (Unaudited)

| (dollars in thousands)  | Capital stock |           | Retained  | Accumulated<br>other<br>comprehensive | Total     |
|---|---------------|-----------|-----------|---------------------------------------|-----------|
|   | Shares        | Amount    | earnings  | income (loss)                         |           |
| Balance, December 31, 2011  | 2,254,542     | \$ 22,354 | \$ 32,380 | \$ (1,110)                            | \$ 53,624 |
| Net income  |               |           | 2,574     |                                       | 2,574     |
| Other comprehensive income  |               |           |           | 772                                   | 772       |
| Issuance of common stock through Employee Stock Purchase Plan                                 | 3,874         | 67        |           |                                       | 67        |
| Issuance of common stock through Dividend Reinvestment Plan                                   | 32,099        | 644       |           |                                       | 644       |
| Stock-based compensation expense  |               | 15        |           |                                       | 15        |
| Cash dividends declared   |               |           | (1,133)   |                                       | (1,133)   |
| Balance, June 30, 2012  | 2,290,515     | \$ 23,080 | \$ 33,821 | \$ (338)                              | \$ 56,563 |
| Balance, December 31, 2012  | 2,323,248     | \$ 23,711 | \$ 34,999 | \$ 236                                | \$ 58,946 |
| Net income  |               |           | 2,907     |                                       | 2,907     |
| Other comprehensive loss  |               |           |           | (1,519)                               | (1,519)   |
| Issuance of common stock through Employee Stock Purchase Plan                                 | 4,256         | 78        |           |                                       | 78        |
| Issuance of common stock through Dividend Reinvestment Plan                                   | 29,191        | 606       |           |                                       | 606       |
| Issuance of common stock from vested restricted share grants through stock compensation plans | 134           |           |           |                                       |           |
| Stock-based compensation expense  |               | 59        |           |                                       | 59        |
| Cash dividends declared   |               |           | (1,174)   |                                       | (1,174)   |
| Balance, June 30, 2013  | 2,356,829     | \$ 24,454 | \$ 36,732 | \$ (1,283)                            | \$ 59,903 |

See notes to unaudited consolidated financial statements

Fidelity D & D Bancorp, Inc. and Subsidiary  
Consolidated Statements of Cash Flows

| (Unaudited)   | Six months ended June<br>30, |          |
|---|------------------------------|----------|
| (dollars in thousands)  | 2013                         | 2012     |
| Cash flows from operating activities:   |                              |          |
| Net income  | \$ 2,907                     | \$ 2,574 |
| Adjustments to reconcile net income to net cash provided by operating activities: |                              |          |
| Depreciation, amortization and accretion  | 1,722                        | 1,750    |
| Provision for loan losses   | 1,150                        | 1,300    |
| Deferred income tax expense (benefit)   | 406                          | (225)    |
| Stock-based compensation expense  | 59                           | 15       |
| Proceeds from sale of loans held-for-sale   | 50,623                       | 39,972   |
| Originations of loans held-for-sale   | (42,730)                     | (32,995) |
| Earnings on bank-owned life insurance   | (166)                        | (161)    |
| Net gain from sales of loans  | (894)                        | (829)    |
| Net gain from sales of investment securities                                      | (111)                        | (251)    |
| Net loss on sale and write-down of foreclosed assets held-for-sale                | 87                           | 75       |
| (Gain) loss on disposal of equipment  | (1)                          | 1        |
| Other-than-temporary impairment on securities                                     | -                            | 136      |
| Change in:  |                              |          |
| Accrued interest receivable   | (94)                         | (61)     |
| Other assets  | (338)                        | 51       |
| Accrued interest payable and other liabilities                                    | (271)                        | (3,812)  |
| Net cash provided by operating activities   | 12,349                       | 7,540    |
| Cash flows from investing activities:   |                              |          |
| Held-to-maturity securities:  |                              |          |
| Proceeds from maturities, calls and principal pay-downs                           | 82                           | 52       |
| Available-for-sale securities:  |                              |          |
| Proceeds from sales   | 756                          | 3,571    |
| Proceeds from maturities, calls and principal pay-downs                           | 15,838                       | 15,505   |
| Purchases   | (15,374)                     | (20,885) |
| (Increase) decrease in FHLB stock   | (590)                        | 361      |
| Net increase in loans and leases  | (32,000)                     | (24,191) |
| Acquisition of bank premises and equipment  | (467)                        | (936)    |
| Proceeds from sale of foreclosed assets held-for-sale                             | 310                          | 164      |
| Net cash used by investing activities   | (31,445)                     | (26,359) |
| Cash flows from financing activities:   |                              |          |
| Net increase (decrease) in deposits   | 4,863                        | (3,733)  |

Edgar Filing: FIDELITY D & D BANCORP INC - Form 10-Q

|   |           |           |
|---|-----------|-----------|
| Net increase (decrease) in short-term borrowings        | 8,143     | (1,401)   |
| Repayments of long-term debt                            | -         | (5,000)   |
| Proceeds from employee stock purchase plan participants | 78        | 67        |
| Dividends paid, net of dividends reinvested             | (727)     | (748)     |
| Proceeds from dividend reinvestment plan participants   | 159       | 260       |
| Net cash provided (used) by financing activities        | 12,516    | (10,555)  |
| Net (decrease) increase in cash and cash equivalents    | (6,580)   | (29,374)  |
| Cash and cash equivalents, beginning                    | 21,846    | 52,165    |
| Cash and cash equivalents, ending                       | \$ 15,266 | \$ 22,791 |

See notes to unaudited consolidated financial statements

FIDELITY D & D BANCORP, INC.

Notes to Consolidated Financial Statements

(Unaudited)

1. Nature of operations and critical accounting policies

Nature of operations

Fidelity Deposit and Discount Bank (the Bank) is a commercial bank chartered in the Commonwealth of Pennsylvania and a wholly-owned subsidiary of Fidelity D & D Bancorp, Inc. (the Company or collectively, the Company). Having commenced operations in 1903, the Bank is committed to provide superior customer service, while offering a full range of banking products and financial and trust services to both our consumer and commercial customers from our main office located in Dunmore and other branches located throughout Lackawanna and Luzerne counties.

Principles of consolidation

The accompanying unaudited consolidated financial statements of the Company and the Bank have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) for interim financial information and with the instructions to this Form 10-Q and Rule 8-03 of Regulation S-X. Accordingly, they do not include all of the information and footnote disclosures required by GAAP for complete financial statements. In the opinion of management, all normal recurring adjustments necessary for a fair presentation of the financial condition and results of operations for the periods have been included. All significant inter-company balances and transactions have been eliminated in consolidation.

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reported periods. Actual results could differ from those estimates. For additional information and disclosures required under GAAP, refer to the Company's Annual Report on Form 10-K for the year ended December 31, 2012.

Management is responsible for the fairness, integrity and objectivity of the unaudited financial statements included in this report. Management prepared the unaudited financial statements in accordance with GAAP. In meeting its responsibility for the financial statements, management depends on the Company's accounting systems and related internal controls. These systems and controls are designed to provide reasonable but not absolute assurance that the financial records accurately reflect the transactions of the Company, the Company's assets are safeguarded and that the financial statements present fairly the financial condition and results of operations of the Company.

In the opinion of management, the consolidated balance sheets as of June 30, 2013 and December 31, 2012 and the related consolidated statements of income and consolidated statements of comprehensive income for the three- and six-months ended June 30, 2013 and 2012, and consolidated statements of changes in shareholders' equity and consolidated statements of cash flows for the six months ended June 30, 2013 and 2012 present fairly the financial condition and results of operations of the Company. All material adjustments required for a fair presentation have been made. These adjustments are of a normal recurring nature. Certain reclassifications have been made to the 2012

financial statements to conform to the 2013 presentation.

This Quarterly Report on Form 10-Q should be read in conjunction with the Company's audited financial statements for the year ended December 31, 2012, and the notes included therein, included within the Company's Annual Report filed on Form 10-K.

#### Critical accounting policies

The presentation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect many of the reported amounts and disclosures. Actual results could differ from these estimates.

A material estimate that is particularly susceptible to significant change relates to the determination of the allowance for loan losses. Management believes that the allowance for loan losses at June 30, 2013 is adequate and reasonable. Given the subjective nature of identifying and valuing loan losses, it is likely that well-informed individuals could make different assumptions and could, therefore, calculate a materially different allowance value. While management uses available information to recognize losses on loans, changes in economic conditions may necessitate revisions in the future. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Company's allowance for loan losses. Such agencies may require the Company to recognize adjustments to the allowance based on their judgment of information available to them at the time of their examination.

Another material estimate is the calculation of fair values of the Company's investment securities. Except for the Company's investment in corporate bonds, consisting of pooled trust preferred securities, fair values of the other investment securities are determined by pricing provided by a third-party vendor, who is a provider of financial market data, analytics and related services

to financial institutions. For the Company's investment in pooled trust preferred securities, management is unable to obtain readily attainable and realistic pricing from market traders due to a lack of active market participants and therefore management has determined the market for these securities to be inactive. In order to determine the fair value of the pooled trust preferred securities, management relied on the use of an income valuation approach (present value technique) that maximizes the use of relevant observable inputs and minimizes the use of unobservable inputs, the results of which are more representative of fair value than the market approach valuation technique used for the other investment securities.

Based on experience, management is aware that estimated fair values of investment securities tend to vary among valuation services. Accordingly, when selling investment securities, price quotes may be obtained from more than one source. The majority of the Company's investment securities are classified as available-for-sale (AFS). AFS securities are carried at fair value on the consolidated balance sheets, with unrealized gains and losses, net of income tax, reported separately within shareholders' equity as a component of accumulated other comprehensive income (loss) (OCI).

The fair value of residential mortgage loans, classified as held-for-sale (HFS), is obtained from the Federal National Mortgage Association (FNMA) or the Federal Home Loan Bank (FHLB). Generally, the market to which the Company sells residential mortgages it originates for sale is restricted and price quotes from other sources are not typically obtained. On occasion, the Company may transfer loans from the loan portfolio to loans HFS. Under these circumstances, pricing may be obtained from other entities and the loans are transferred at the lower of cost or market value and simultaneously sold. As of June 30, 2013 and December 31, 2012, loans classified as HFS consisted of residential mortgage loans.

During the first quarter of 2013, the Company commenced its automobile leasing operations, a component of auto loans and leases in the consumer segment of the loan portfolio. Financing of automobiles, provided to customers under lease arrangements of varying terms, are accounted for as direct finance leases. Interest on automobile direct finance leasing is determined using the interest method. Generally, the interest method is used to arrive at a level effective yield over the life of the lease.

Foreclosed assets held-for-sale includes other real estate acquired through foreclosure (ORE) and may, from time-to-time, include repossessed assets such as automobiles. ORE is carried at the lower of cost (principal balance at date of foreclosure) or fair value less estimated cost to sell. Any write-downs at the date of foreclosure or within a reasonable period of time after foreclosure are charged to the allowance for loan losses. Expenses incurred to maintain ORE properties, subsequent write downs to the asset's fair value and gains or losses on disposal are included as components of other real estate owned expense in the consolidated statements of income.

For purposes of the consolidated statements of cash flows, cash and cash equivalents includes cash on hand, amounts due from banks and interest-bearing deposits with financial institutions. For the six months ended June 30, 2013 and 2012, the Company paid interest of \$1.5 million and \$1.8 million, respectively. The Company was required to pay income taxes of \$0.9 million and \$1.2 million during the first six months of 2013 and 2012, respectively. Transfers from loans to foreclosed assets held-for-sale amounted to \$1.4 million and \$1.2 million during the six months ended June 30, 2013 and 2012. During the same respective periods, transfers from loans to loans HFS amounted to \$2.7 million and \$2.0 million. Expenditures for construction in process, a component of other assets in the consolidated balance sheets, are included in acquisition of bank premises and equipment.

## 2. New Accounting Pronouncements

In February 2013, the Financial Accounting Standards Board (FASB) issued the accounting update related to; Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income. The update requires entities to present information about reclassification adjustments from accumulated other comprehensive income in their annual financial statements in a single note or on the face of the financial statements. The new requirement is effective



prospectively for interim and annual reporting periods beginning after December 15, 2012. The provisions of this accounting update require expanded financial reporting disclosures.

3. Accumulated other comprehensive income (loss)

The following tables illustrate the changes in accumulated other comprehensive income (loss) by component and the details about the components of accumulated comprehensive income (loss) as of and for the periods indicated:

8

---

Edgar Filing: FIDELITY D & D BANCORP INC - Form 10-Q

As of and for the six months ended June 30, 2013

| (dollars in thousands)  | Unrealized<br>gains<br>on<br>available-for-<br>sale securities | Non-credit-related<br>impairment losses<br>on investment<br>securities | Total      |
|---|--|--|------------|
| Beginning balance   | \$ 1,905   | \$ (1,669)   | \$ 236     |
| Other comprehensive (loss) income before reclassifications          | (1,469)  | 35   | (1,434)    |
| Amounts reclassified from accumulated other<br>comprehensive income | (85)   | -  | (85)       |
| Net current-period other comprehensive (loss) income                | (1,554)  | 35   | (1,519)    |
| Ending balance  | \$ 351   | \$ (1,634)   | \$ (1,283) |

As of and for the three months ended June 30, 2013

| (dollars in thousands)  | Unrealized<br>gains<br>on<br>available-for-<br>sale securities | Non-credit-related<br>impairment losses<br>on investment<br>securities | Total      |
|---|--|--|------------|
| Beginning balance   | \$ 1,551   | \$ (1,695)   | \$ (144)   |
| Other comprehensive (loss) income before reclassifications          | (1,194)  | 61   | (1,133)    |
| Amounts reclassified from accumulated other<br>comprehensive income | (6)  | -  | (6)        |
| Net current-period other comprehensive (loss) income                | (1,200)  | 61   | (1,139)    |
| Ending balance  | \$ 351   | \$ (1,634)   | \$ (1,283) |

In the tables above, all amounts are net of tax at 34%. Amounts in parentheses indicate debits.

Edgar Filing: FIDELITY D & D BANCORP INC - Form 10-Q

| Details about accumulated other comprehensive income components | Amount reclassified from accumulated other comprehensive income | Affected line item in the statement where net income is presented |
|---|---|---|
| (dollars in thousands)  |   |   |
| For the six months ended June 30, 2013                          |   |   |
| Unrealized gains on AFS securities                              | \$ 128  | Gain on sale, recovery, or disposal of investment securities      |
|   | -   | Net impairment losses on investment securities                    |
|   | 128   | Income before income taxes  |
|   | (43)  | Provision for income taxes  |
| Total reclassifications for the period                          | \$ 85   | Net income  |
| For the three months ended June 30, 2013                        |   |   |
| Unrealized gains on AFS securities                              | \$ 9  | Gain on sale, recovery, or disposal of investment securities      |
|   | -   | Net impairment losses on investment securities                    |
|   | 9   | Income before income taxes  |
|   | (3)   | Provision for income taxes  |
| Total reclassifications for the period                          | \$ 6  | Net income  |

## 4. Investment securities

The amortized cost and fair value of investment securities at June 30, 2013 and December 31, 2012 are summarized as follows:

| (dollars in thousands)                              | Amortized<br>cost | Gross<br>unrealized<br>gains | Gross<br>unrealized<br>losses | Fair<br>value |
|---|-------------------|------------------------------|-------------------------------|---------------|
| June 30, 2013                                       |                   |                              |                               |               |
| Held-to-maturity securities:                        |                   |                              |                               |               |
| MBS - GSE residential                               | \$ 207            | \$ 20                        | \$ -                          | \$ 227        |
| Available-for-sale securities:                      |                   |                              |                               |               |
| Agency - GSE  | \$ 13,168         | \$ 35                        | \$ 25                         | \$ 13,178     |
| Obligations of states and<br>political subdivisions | 31,726            | 1,231                        | 416                           | 32,541        |
| Corporate bonds:                                    |                   |                              |                               |               |
| Pooled trust preferred securities                   | 6,203             | 222                          | 4,302                         | 2,123         |
| MBS - GSE residential                               | 46,812            | 1,301                        | 192                           | 47,921        |
| Total debt securities                               | 97,909            | 2,789                        | 4,935                         | 95,763        |
| Equity securities - financial services              | 295               | 201                          | -                             | 496           |
| Total available-for-sale securities                 | \$ 98,204         | \$ 2,990                     | \$ 4,935                      | \$ 96,259     |

| (dollars in thousands)                              | Amortized<br>cost | Gross<br>unrealized<br>gains | Gross<br>unrealized<br>losses | Fair<br>value |
|---|-------------------|------------------------------|-------------------------------|---------------|
| December 31, 2012                                   |                   |                              |                               |               |
| Held-to-maturity securities:                        |                   |                              |                               |               |
| MBS - GSE residential                               | \$ 289            | \$ 31                        | \$ -                          | \$ 320        |
| Available-for-sale securities:                      |                   |                              |                               |               |
| Agency - GSE  | \$ 17,651         | \$ 102                       | \$ 13                         | \$ 17,740     |
| Obligations of states and<br>political subdivisions | 26,979            | 2,879                        | 1                             | 29,857        |
| Corporate bonds:                                    |                   |                              |                               |               |

Edgar Filing: FIDELITY D & D BANCORP INC - Form 10-Q

|  |            |          |          |            |
|--|------------|----------|----------|------------|
| Pooled trust preferred securities      | 6,323      | 185      | 4,683    | 1,825      |
| MBS - GSE residential                  | 48,836     | 1,761    | 44       | 50,553     |
| Total debt securities                  | 99,789     | 4,927    | 4,741    | 99,975     |
| Equity securities - financial services | 295        | 171      | -        | 466        |
| Total available-for-sale securities    | \$ 100,084 | \$ 5,098 | \$ 4,741 | \$ 100,441 |

10

---

Edgar Filing: FIDELITY D & D BANCORP INC - Form 10-Q

The amortized cost and fair value of debt securities at June 30, 2013 by contractual maturity are summarized below:

| (dollars in thousands)                   | Amortized<br>cost | Fair<br>value |
|--|-------------------|---------------|
| Held-to-maturity securities:             |                   |               |
| MBS - GSE residential                    | \$ 207            | \$ 227        |
| Available-for-sale securities:           |                   |               |
| Debt securities:                         |                   |               |
| Due in one year or less                  | \$ 2,864          | \$ 2,873      |
| Due after one year through five years    | 10,150            | 10,152        |
| Due after five years through ten years   | 2,994             | 3,104         |
| Due after ten years                      | 35,089            | 31,713        |
| Total debt securities                    | 51,097            | 47,842        |
| MBS - GSE residential                    | 46,812            | 47,921        |
| Total available-for-sale debt securities | \$ 97,909         | \$ 95,763     |

Actual maturities will differ from contractual maturities because issuers and borrowers may have the right to call or repay obligations with or without call or prepayment penalty. Agency – GSE and municipal securities are included based on their original stated maturity. MBS – GSE residential, which are based on weighted-average lives and subject to monthly principal pay-downs, are listed in total.

The following table presents the fair value and gross unrealized losses of investment securities aggregated by investment type, the length of time and the number of securities that have been in a continuous unrealized loss position as of June 30, 2013 and December 31, 2012:

| (dollars in thousands)                           | Less than 12 months |                      | More than 12 months |                      | Total         |                      |
|--|---------------------|----------------------|---------------------|----------------------|---------------|----------------------|
|  | Fair<br>value       | Unrealized<br>losses | Fair<br>value       | Unrealized<br>losses | Fair<br>value | Unrealized<br>losses |
| June 30, 2013                                    |                     |                      |                     |                      |               |                      |
| Agency - GSE                                     | \$ 3,081            | \$ 25                | \$ -                | \$ -                 | \$ 3,081      | \$ 25                |
| Obligations of states and political subdivisions | 8,361               | 416                  | -                   | -                    | 8,361         | 416                  |
| Corporate bonds:                                 |                     |                      |                     |                      |               |                      |
| Pooled trust preferred securities                | -                   | -                    | 1,490               | 4,302                | 1,490         | 4,302                |
| MBS - GSE residential                            | 11,764              | 192                  | -                   | -                    | 11,764        | 192                  |
| Total temporarily impaired securities            | \$ 23,206           | \$ 633               | \$ 1,490            | \$ 4,302             | \$ 24,696     | \$ 4,935             |

Edgar Filing: FIDELITY D & D BANCORP INC - Form 10-Q

|  |          |       |          |          |          |          |
|--|----------|-------|----------|----------|----------|----------|
| Number of securities                             | 26       |       | 7        |          | 33       |          |
| December 31, 2012                                |          |       |          |          |          |          |
| Agency - GSE                                     | \$ 1,017 | \$ 13 | \$ -     | \$ -     | \$ 1,017 | \$ 13    |
| Obligations of states and political subdivisions | 281      | 1     | -        | -        | 281      | 1        |
| Corporate bonds:                                 |          |       |          |          |          |          |
| Pooled trust preferred securities                | -        | -     | 1,639    | 4,683    | 1,639    | 4,683    |
| MBS - GSE residential                            | 6,214    | 44    | -        | -        | 6,214    | 44       |
| Total temporarily impaired securities            | \$ 7,512 | \$ 58 | \$ 1,639 | \$ 4,683 | \$ 9,151 | \$ 4,741 |
| Number of securities                             | 5        |       | 8        |          | 13       |          |

Most of the securities in the investment portfolio have fixed rates or have predetermined scheduled rate changes, and many have call features that allow the issuer to call the security at par before its stated maturity, without penalty. Management believes the

cause of the unrealized losses is related to changes in interest rates, instability in the capital markets or the limited trading activity due to illiquid conditions in the debt market and is not directly related to credit quality.

Management conducts a formal review of investment securities on a quarterly basis for the presence of other-than-temporary impairment (OTTI). The accounting guidance related to OTTI requires the Company to assess whether OTTI is present when the fair value of a debt security is less than its amortized cost as of the balance sheet date. Under those circumstances, OTTI is considered to have occurred if: (1) the entity has intent to sell the security; (2) more likely than not the entity will be required to sell the security before recovery of its amortized cost basis; or (3) the present value of expected cash flows is not sufficient to recover the entire amortized cost.

The accounting guidance requires that credit-related OTTI be recognized in earnings while non-credit-related OTTI on securities not expected to be sold be recognized in other comprehensive income (loss) (OCI). Non-credit-related OTTI is based on other factors affecting market value, including illiquidity. Presentation of OTTI is made in the consolidated statements of income on a gross basis with an offset for the amount of non-credit-related OTTI recognized in OCI.

The Company's OTTI evaluation process also follows the guidance set forth in topics related to debt and equity securities. The guidance set forth in the pronouncements require the Company to take into consideration current market conditions, fair value in relationship to cost, extent and nature of changes in fair value, issuer rating changes and trends, volatility of earnings, current analysts' evaluations, all available information relevant to the collectability of debt securities, the ability and intent to hold investments until a recovery of fair value which may be to maturity and other factors when evaluating for the existence of OTTI. The guidance requires that credit-related OTTI be recognized as a realized loss through earnings when there has been an adverse change in the holder's expected cash flows such that the full amount (principal and interest) will probably not be received. This requirement is consistent with the impairment model in the guidance for accounting for debt and equity securities.

For all security types, as of June 30, 2013, the Company applied the criteria provided in the recognition and presentation guidance related to OTTI. That is, management has no intent to sell the securities and no conditions were identified by management that more likely than not would require the Company to sell the securities before recovery of their amortized cost basis. The results indicated there was no presence of OTTI in the Company's portfolios of Agency – Government Sponsored Enterprise (GSE), Mortgage-backed securities (MBS) – GSE residential and Obligations of states and political subdivisions. Following is a description of the security types within the Company's investment portfolio.

#### Agency - GSE and MBS - GSE residential

Agency – GSE and MBS – GSE residential securities consist of short- and medium-term notes issued by Federal Home Loan Mortgage Corporation (FHLMC), Federal National Mortgage Association (FNMA), Federal Home Loan Bank (FHLB), Federal Farm Credit Bank (FFCB) and Government National Mortgage Association (GNMA). These securities have interest rates that are fixed and adjustable, have varying short- to mid-term maturity dates and have contractual cash flows guaranteed by the U.S. government or agencies of the U.S. government.

#### Obligations of states and political subdivisions

The municipal securities are bank qualified or bank eligible, general obligation and revenue bonds rated as investment grade by various credit rating agencies and have fixed rates of interest with mid- to long-term maturities. Fair values of these securities are highly driven by interest rates. Management performs ongoing credit quality reviews on these issues.

In the above security types, management believes the change in fair value is attributable to changes in interest rates and those instruments with unrealized losses were not caused by deterioration of credit quality. Accordingly, as of



June 30, 2013, recognition of OTTI on these securities was unnecessary.

#### Pooled trust preferred securities

A Pooled Trust Preferred Collateralized Debt Obligation (CDO) is a type of investment security collateralized by trust preferred securities (TPS) issued by banks, insurance companies and real estate investment trusts. The primary collateral type is a TPS issued by a bank. A TPS is a hybrid security that consists of both debt and equity characteristics which includes the ability of the issuer to voluntarily defer interest payments for up to 20 consecutive quarters. A TPS is considered a junior security in the capital structure of the issuer.

There are various investment classes or tranches issued by the CDO. The most senior tranche has the lowest yield but the most protection from credit losses. Conversely, the most junior tranche has the highest yield but the most exposure to risk of credit loss. Junior tranches are subordinate to senior tranches and losses are generally allocated from the lowest tranche with the equity component holding the most risk of credit loss and then subordinate tranches in reverse order up to the most senior tranche. The allocation of losses is defined in the indenture when the CDO was formed.

Unrealized losses in the pooled trust preferred securities (PreTSLs) are caused mainly by: (1) collateral deterioration due to bank failures and credit concerns across the banking sector; (2) widening of credit spreads and (3) illiquidity in the market. The Company's review of its portfolio of pooled trust preferred securities determined that in 2012 credit-related OTTI be recorded on two holdings, both of which are contained in the Company's AFS securities portfolio, from credit quality downgrades on the underlying collateral, including the collateral of four banks deferring interest payments within these two securities and one bank

fully redeeming which removes all future earnings cash flow. There was no credit related OTTI required to be recognized during the three or six months ended June 30, 2013.

The following table summarizes the amount of OTTI recognized in earnings, by security during the periods indicated:

| (dollars in thousands)             | Three months ended |       | Six months ended |        |
|------------------------------------|--------------------|-------|------------------|--------|
|                                    | June 30, 2013      | 2012  | June 30, 2013    | 2012   |
| Pooled trust preferred securities: |                    |       |                  |        |
| PreTSL IX, B1, B3                  | \$ -               | \$ -  | \$ -             | \$ 18  |
| PreTSL XVIII, C                    | -                  | 31    | -                | 118    |
| Total                              | \$ -               | \$ 31 | \$ -             | \$ 136 |

The following is a tabular roll-forward of the cumulative amount of credit-related OTTI recognized in earnings:

| (dollars in thousands)   | Six months ended |             |             |
|--|------------------|-------------|-------------|
|  | June 30, 2013    |             |             |
|  | HTM              | AFS         | Total       |
| Beginning balance of credit-related OTTI   | \$ -             | \$ (15,416) | \$ (15,416) |
| Additions for credit-related OTTI not previously recognized  | -                | -           | -           |
| Additional credit-related OTTI previously recognized when there is no intent to sell before recovery of amortized cost basis | -                | -           | -           |
| Ending balance of credit-related OTTI  | \$ -             | \$ (15,416) | \$ (15,416) |

To determine credit-related OTTI, the Company analyzes the collateral of each individual tranche within each of the 13 individual pools in the Company's portfolio of PreTSLs. The Company engaged a third party structured finance firm to: review the underlying collateral of each PreTSL; research trustee reports to update relevant data and credit ratings of the underlying collateral; project default rates and cash flows of the collateral and simulate 10,000 Monte Carlo time-to-default scenarios, performed quarterly, to arrive at the single best estimate of future cash flow for each tranche.

The sub-topics of the Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 320 provide the scope, steps and accounting guidance for impairment: 1) determine whether an investment is impaired; 2) evaluate whether impairment is other-than-temporary; then 3) recognition of OTTI. The guidance in ASC 320 retains

and emphasizes the objective of OTTI assessment and the related disclosure requirements by aligning the OTTI methodology for certain securitizations. ASC 325 provides a scope exception for investments that were considered of high credit quality (i.e. rated "AA" or higher) at the time of acquisition. The application of the guidance contained in ASC 320 is used for two investments considered of high credit quality and ASC 325 is used for the remaining eleven securities. In summary, the quarterly evaluations indicated there was no significant adverse change in cash flows in the securities. As a result, there was no credit related OTTI recorded during the three- and six- months ended June 30, 2013.

The guidance prescribed in ASC 320 is used for investments that, upon purchase, were rated of high credit quality, "AA" or higher, by a nationally recognized statistical rating organization. The Company has two PreTSLs (XXIV and XXVII) that were of high credit quality, "AA" rated, upon acquisition. PreTSL XXVII evaluation proved a high probability that the Company will be able to collect all amounts due, both principal and interest, by maturity and thus, determined the impairment is temporary. PreTSL XXIV was evaluated under ASC 320 to determine if the Company expects to recover the remaining amortized cost basis and whether OTTI is deemed to have occurred. An adverse change or short-fall in the expected cash flows compared to the amortized cost would be recorded as credit-related OTTI. To assess the likelihood of recoverability, the present value of the best estimate of future cash flows is compared to the amortized cost. In this situation, the discount rate used was the interest rate implicit in the security at the date of acquisition. The application of the guidance on this security did not result in an adverse change in cash flows when compared to the previous measurement date and therefore, no credit related OTTI has been recorded during 2013.

The remaining eleven PreTSLs were rated "A" by a nationally recognized statistical rating organization at the date of acquisition and as such are considered beneficial interests of securitized financial assets. For these securities, the Company applies the guidance of ASC 325. Under this and other relevant guidance, if the fair value is below amortized cost and the present value of the best estimate of future cash flows declines significantly, evidencing a probable material adverse change in cash flows since the previous measurement date, credit-related OTTI is deemed to exist and written down to the determined present value through a charge to current earnings. The discount rate used under ASC 325 is the yield to accrete beneficial interest, which is representative

of the resulting interest from the total gross estimated future cash flows less the current amortized cost. In applying this guidance to the remaining securities, none of the securities measured an adverse change in cash flows and therefore no credit related OTTI has been recorded during 2013.

The following table is the composition of the Company's non-accrual PreTSL securities as of the period indicated:

| (dollars in thousands) |           | June 30, 2013 |            | December 31, 2012 |            |
|------------------------|-----------|---------------|------------|-------------------|------------|
|                        |           | Book value    | Fair value | Book value        | Fair value |
| Deal                   | Class     |               |            |                   |            |
| Pre TSL V              | Mezzanine | \$ -          | \$ 25      | \$ -              | \$ 27      |
| Pre TSL VII            | Mezzanine | -             | 126        | -                 | 125        |
| Pre TSL IX             | B-1,B-3   | 1,469         | 569        | 1,507             | 630        |
| Pre TSL XI             | B-3       | 985           | 302        | 1,053             | 305        |
| Pre TSL XV             | B-1       | -             | 44         | -                 | 33         |
| Pre TSL XVIII          | C         | 167           | -          | 167               | -          |
| Pre TSL XIX            | C         | 316           | 5          | 316               | -          |
| Pre TSL XXIV           | B-1       | 407           | 18         | 407               | 12         |
|                        |           | \$ 3,344      | \$ 1,089   | \$ 3,450          | \$ 1,132   |

Non-accrual securities have experienced impairment of principal, and interest was "paid-in-kind". When these two conditions exist, the security is placed on non-accrual status. Quarterly, each of the other PreTSL issues is evaluated for the presence of these two conditions and if necessary placed on non-accrual status.

The following table provides additional information with respect to the Company's pooled trust preferred securities as of June 30, 2013:

(dollars in thousands)

| Deal       | Class     | Book value | Fair value | Unrealized gain (loss) | Fitch ratings (1) | Current                               | Actual                 | Excess   | Effective  |      |      |
|------------|-----------|------------|------------|------------------------|-------------------|---------------------------------------|------------------------|--|--|------|------|
|            |           |            |            |                        |                   | number of banks / insurance companies | deferrals and defaults | subordinations as a % of current performing collateral | subordinations as a % of current performing collateral |      |      |
| Pre TSL IV | Mezzanine | \$ 412     | \$ 439     | \$ 27                  | CCC               | 6 / -                                 | \$ 12,000              | 18.0   | \$ 16,415  | 28.3 | 39.6 |
|            | Mezzanine | -          | 25         | 25                     | C / D             | 3 / -                                 | 28,950                 | 100.0  | None   | N/A  | N/A  |

Edgar Filing: FIDELITY D & D BANCORP INC - Form 10-Q

|                             |          |          |            |              |         |         |      |       |     |      |  |  |
|-----------------------------|----------|----------|------------|--------------|---------|---------|------|-------|-----|------|--|--|
| Pre<br>TSL V                |          |          |            |              |         |         |      |       |     |      |  |  |
| Pre<br>TSL<br>VII Mezzanine | -        | 126      | 126        | Ca / C       | 15 / -  | 85,000  | 52.8 | None  | N/A | N/A  |  |  |
| Pre<br>TSL IXB-1,B-3        | 1,469    | 569      | (900)      | Ca / C       | 46 / -  | 101,280 | 27.0 | None  | N/A | 4.9  |  |  |
| Pre<br>TSL XIB-3            | 985      | 302      | (683)      | Ca / C       | 60 / -  | 167,250 | 29.8 | None  | N/A | 1.2  |  |  |
| Pre<br>TSL<br>XV B-1        | -        | 44       | 44         | C / C        | 61 / 7  | 173,200 | 30.8 | None  | N/A | N/A  |  |  |
| Pre<br>TSL<br>XVI C         | -        | -        | -          | C / C        | 47 / 6  | 241,570 | 43.4 | None  | N/A | N/A  |  |  |
| Pre<br>TSL<br>XVII C        | -        | -        | -          | C / C        | 49 / 6  | 177,390 | 38.8 | None  | N/A | N/A  |  |  |
| Pre<br>TSL<br>XVIII C       | 167      | -        | (167)      | Ca / C       | 63 / 14 | 194,140 | 30.4 | None  | N/A | N/A  |  |  |
| Pre<br>TSL<br>XIX C         | 316      | 5        | (311)      | C / C        | 51 / 14 | 140,150 | 22.9 | None  | N/A | 1.9  |  |  |
| Pre<br>TSL<br>XXIV B-1      | 407      | 18       | (389)      | Ca<br>/ CC   | 77 / 11 | 347,500 | 34.8 | None  | N/A | 15.0 |  |  |
| Pre<br>TSL<br>XXV C-1       | -        | -        | -          | C / C        | 61 / 7  | 257,000 | 33.5 | None  | N/A | 1.7  |  |  |
| Pre<br>TSL<br>XXVII B       | 2,447    | 595      | (1,852)    | Caa3 /<br>CC | 40 / 7  | 81,800  | 26.1 | 9,559 | 4.1 | 27.8 |  |  |
|                             | \$ 6,203 | \$ 2,123 | \$ (4,080) |              |         |         |      |       |     |      |  |  |

(1) All ratings have been updated through June 30, 2013.

(2) Excess subordination represents the excess (if any) of the amount of performing collateral over the given class of bonds.

(3) Effective subordination represents the estimated percentage of the performing collateral that would need to defer or default at the next payment in order to trigger a loss of principal or interest. This differs from excess subordination in that it considers the effect of excess interest earned on the performing collateral.

For a further discussion on the fair value determination of the Company's investment in PreTSLs and other financial instruments, see Note 8, "Fair value measurements".



## 5. Loans and leases

The classifications of loans and leases at June 30, 2013 and December 31, 2012 are summarized as follows:

| (dollars in thousands)     | June 30,<br>2013 | December<br>31, 2012 |
|----------------------------|------------------|----------------------|
| Commercial and industrial  | \$ 71,352        | \$ 65,110            |
| Commercial real estate:    |                  |                      |
| Non-owner occupied         | 90,303           | 81,998               |
| Owner occupied             | 79,547           | 80,509               |
| Construction               | 10,207           | 10,679               |
| Consumer:                  |                  |                      |
| Home equity installment    | 34,823           | 32,828               |
| Home equity line of credit | 34,280           | 34,169               |
| Auto loans and leases      | 19,202           | 17,411               |
| Other                      | 5,360            | 6,139                |
| Residential:               |                  |                      |
| Real estate                | 105,675          | 96,765               |
| Construction               | 9,253            | 7,948                |
| Total                      | 460,002          | 433,556              |
| Less:                      |                  |                      |
| Allowance for loan losses  | (8,296)          | (8,972)              |
| Unearned lease revenue     | (41)             | -                    |
| Loans and leases, net      | \$ 451,665       | \$ 424,584           |

Net deferred loan costs of \$1.0 million have been added to the carrying values of loans at June 30, 2013 and December 31, 2012, respectively.

The Company services real estate loans for investors in the secondary mortgage market which are not included in the accompanying consolidated balance sheets. The approximate amount of mortgages serviced amounted to \$229.4 million as of June 30, 2013 and \$214.7 million as of December 31, 2012.

The Company utilizes an external independent loan review firm that reviews and validates the credit risk program on at least an annual basis. Results of these reviews are presented to management and the Board of Directors. The loan review process complements and reinforces the risk identification and assessment decisions made by lenders and credit personnel, as well as the Company's policies and procedures.

## Non-accrual loans

The decision to place loans on non-accrual status is made on an individual basis after considering factors pertaining to each specific loan. Commercial and industrial and commercial real estate loans are placed on non-accrual status when management has determined that payment of all contractual principal and interest is in doubt or the loan is past due 90

days or more as to principal and interest, unless well-secured and in the process of collection. Consumer loans secured by real estate and residential mortgage loans are placed on non-accrual status at 120 days past due as to principal and interest and unsecured consumer loans are charged off when the loan is 90 days or more past due as to principal and interest. The Company considers all non-accrual loans to be impaired loans.

15

---



Non-accrual loans, segregated by class, at June 30, 2013 and December 31, 2012, were as follows:

| (dollars in thousands)     | June 30,<br>2013 | December<br>31, 2012 |
|----------------------------|------------------|----------------------|
| Commercial and industrial  | \$ 9             | \$ 18                |
| Commercial real estate:    |                  |                      |
| Non-owner occupied         | 1,698            | 1,884                |
| Owner occupied             | 1,488            | 5,031                |
| Construction               | 857              | 1,123                |
| Consumer:                  |                  |                      |
| Home equity installment    | 778              | 1,306                |
| Home equity line of credit | 334              | 381                  |
| Other                      | 32               | 48                   |
| Residential:               |                  |                      |
| Real estate                | 1,514            | 2,330                |
| Total                      | \$ 6,710         | \$ 12,121            |

#### Troubled Debt Restructuring

A modification of a loan constitutes a troubled debt restructuring (TDR) when a borrower is experiencing financial difficulty and the modification constitutes a concession. The Company considers all TDRs to be impaired loans. The Company offers various types of concessions when modifying a loan, however, forgiveness of principal is rarely granted. Commercial and industrial loans modified in a TDR often involve temporary interest-only payments, term extensions, and converting revolving credit lines to term loans. Additional collateral, a co-borrower, or a guarantor is often requested. Commercial real estate and construction loans modified in a TDR often involve reducing the interest rate for the remaining term of the loan, extending the maturity date at an interest rate lower than the current market rate for new debt with similar risk, or substituting or adding a new borrower or guarantor. Construction loans modified in a TDR may also involve extending the interest-only payment period. Residential mortgage loans modified in a TDR are primarily comprised of loans where monthly payments are lowered to accommodate the borrowers' financial needs for an extended period of time. After the lowered monthly payment period ends, the borrower would revert back to paying principal and interest per the original terms with the maturity date adjusted accordingly. Home equity and automobile loan modifications are typically not granted and therefore standard modification terms do not exist for loans of this type.

Loans modified in a TDR may or may not be placed on non-accrual status. As of June 30, 2013, total TDRs amounted to \$2.1 million, of which \$1.0 million were on non-accrual status. This was a slight reduction from the December 31, 2012 total of \$2.2 million of which \$1.1 million were on non-accrual status.

Loans modified in a TDR are closely monitored for delinquency as an early indicator of possible future default. If loans modified in a TDR subsequently default, the Company evaluates the loan for possible further impairment. There were no loans modified in a TDR during the three- and six-months ended June 30, 2013. There were no loans modified in a TDR during the twelve months ended June 30, 2013 that subsequently defaulted during the three- or six months ended June 30, 2013.

The allowance may be increased, adjustments may be made in the allocation of the allowance or partial charge offs may be taken to further write-down the carrying value of the loan. An allowance for impaired loans that have been modified in a TDR is measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or the loan's observable market price. If the loan is collateral dependent, the estimated fair value of the collateral, less any selling costs, is used to establish the allowance.

## Past due loans

Loans are considered past due when the contractual principal and/or interest are not received by the due date. An aging analysis of past due loans, segregated by class of loans, as of the period indicated is as follows (dollars in thousands):

|                            | 30 - 59<br>Days<br>past due | 60 -<br>89<br>Days<br>past<br>due | Past due                |                   | Current    | Total<br>loans<br>receivables | Recorded<br>investment past<br>due ≥ 90 days<br>and accruing |
|----------------------------|-----------------------------|-----------------------------------|-------------------------|-------------------|------------|-------------------------------|--|
|                            |                             |                                   | 90 days<br>or more<br>* | Total<br>past due |            |                               |  |
| June 30, 2013              |                             |                                   |                         |                   |            |                               |  |
| Commercial and industrial  | \$ 291                      | \$ -                              | \$ 233                  | \$ 524            | \$ 70,828  | \$ 71,352                     | \$ 224   |
| Commercial real estate:    |                             |                                   |                         |                   |            |                               |  |
| Non-owner occupied         | 115                         | 199                               | 1,973                   | 2,287             | 88,016     | 90,303                        | 275  |
| Owner occupied             | 155                         | -                                 | 1,528                   | 1,683             | 77,864     | 79,547                        | 40   |
| Construction               | -                           | -                                 | 857                     | 857               | 9,350      | 10,207                        | -  |
| Consumer:                  |                             |                                   |                         |                   |            |                               |  |
| Home equity installment    | 87                          | 23                                | 803                     | 913               | 33,910     | 34,823                        | 25   |
| Home equity line of credit | 23                          | 99                                | 337                     | 459               | 33,821     | 34,280                        | 3  |
| Auto loans and leases      | 289                         | 29                                | -                       | 318               | 18,843     | 19,161                        | -  |
| Other                      | 7                           | 4                                 | 32                      | 43                | 5,317      | 5,360                         | -  |
| Residential:               |                             |                                   |                         |                   |            |                               |  |
| Real estate                | 205                         | 395                               | 1,940                   | 2,540             | 103,135    | 105,675                       | 426  |
| Construction               | -                           | -                                 | -                       | -                 | 9,253      | 9,253                         | -  |
| Total                      | \$ 1,172                    | \$ 749                            | \$ 7,703                | \$ 9,624          | \$ 450,337 | \$ 459,961                    | \$ 993   |

\* Includes \$6.7 million of non-accrual loans.

|                           | 30 - 59<br>Days<br>past due | 60 - 89<br>Days<br>past due | Past due                |                   | Current   | Total<br>loans<br>receivables | Recorded<br>investment past<br>due ≥ 90 days<br>and accruing |
|---------------------------|-----------------------------|-----------------------------|-------------------------|-------------------|-----------|-------------------------------|--|
|                           |                             |                             | 90 days<br>or more<br>* | Total<br>past due |           |                               |  |
| December 31, 2012         |                             |                             |                         |                   |           |                               |  |
| Commercial and industrial | \$ 676                      | \$ 15                       | \$ 254                  | \$ 945            | \$ 64,165 | \$ 65,110                     | \$ 236   |
| Commercial real estate:   |                             |                             |                         |                   |           |                               |  |
| Non-owner occupied        | -                           | 141                         | 1,884                   | 2,025             | 79,973    | 81,998                        | -  |
| Owner occupied            | 208                         | 282                         | 5,439                   | 5,929             | 74,580    | 80,509                        | 408  |

Edgar Filing: FIDELITY D & D BANCORP INC - Form 10-Q

|                            |          |          |           |           |            |            |          |
|----------------------------|----------|----------|-----------|-----------|------------|------------|----------|
| Construction               | -        | -        | 1,123     | 1,123     | 9,556      | 10,679     | -        |
| Consumer:                  |          |          |           |           |            |            |          |
| Home equity installment    | 216      | 132      | 1,325     | 1,673     | 31,155     | 32,828     | 19       |
| Home equity line of credit | -        | 66       | 381       | 447       | 33,722     | 34,169     | -        |
| Auto                       | 459      | 30       | 16        | 505       | 16,906     | 17,411     | 16       |
| Other                      | 48       | 4        | 65        | 117       | 6,022      | 6,139      | 17       |
| Residential:               |          |          |           |           |            |            |          |
| Real estate                | 99       | 544      | 3,357     | 4,000     | 92,765     | 96,765     | 1,027    |
| Construction               | -        | -        | -         | -         | 7,948      | 7,948      | -        |
| Total                      | \$ 1,706 | \$ 1,214 | \$ 13,844 | \$ 16,764 | \$ 416,792 | \$ 433,556 | \$ 1,723 |

\* Includes \$12.1 million of non-accrual loans.

#### Impaired loans

A loan is considered impaired when, based on current information and events; it is probable that the Company will be unable to collect the scheduled payments in accordance with the contractual terms of the loan. Factors considered in determining impairment include payment status, collateral value and the probability of collecting payments when due. The significance of payment delays and/or shortfalls is determined on a case-by-case basis. All circumstances surrounding the loan are taken into account. Such factors include the length of the delinquency, the underlying reasons and the borrower's prior payment record. Impairment is measured on these loans on a loan-by-loan basis. Impaired loans may include non-accrual loans, TDRs and other loans deemed to be impaired based on the aforementioned factors. As of June 30, 2013 and December 31, 2012, impaired loans consisted of non-accrual loans and TDRs.

At June 30, 2013, impaired loans consisted of accruing TDRs totaling \$1.1 million and \$6.7 million of non-accrual loans. At December 31, 2012, impaired loans consisted of accruing TDRs totaling \$1.1 million and \$12.1 million of non-accrual loans. As of June 30, 2013 and December 31, 2012, the non-accrual loans included non-accruing TDRs of \$1.0 million and \$1.1 million. Payments received from impaired loans are first applied against the outstanding principal balance, then to the recovery of any charged-off amounts. Any excess is treated as a recovery of interest income.

Edgar Filing: FIDELITY D & D BANCORP INC - Form 10-Q

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

| (dollars in thousands)     | Unpaid principal balance | Recorded investment with allowance | Recorded investment with no allowance | Total recorded investment | Related allowance | Average recorded investment | Interest income recognized | Cash basis interest income recognized |
|----------------------------|--------------------------|------------------------------------|---------------------------------------|---------------------------|-------------------|-----------------------------|----------------------------|---------------------------------------|
| June 30, 2013              |                          |                                    |                                       |                           |                   |                             |                            |                                       |
| Commercial & industrial    | \$ 49                    | \$ -                               | \$ 49                                 | \$ 49                     | \$ -              | \$ 117                      | \$ 1                       | \$ -                                  |
| Commercial real estate:    |                          |                                    |                                       |                           |                   |                             |                            |                                       |
| Non-owner occupied         | 2,208                    | 463                                | 1,725                                 | 2,188                     | 82                | 2,977                       | 16                         | 39                                    |
| Owner occupied             | 3,164                    | 1,134                              | 902                                   | 2,036                     | 103               | 5,170                       | 22                         | -                                     |
| Construction               | 1,110                    | 210                                | 647                                   | 857                       | 3                 | 1,073                       | -                          | -                                     |
| Consumer:                  |                          |                                    |                                       |                           |                   |                             |                            |                                       |
| Home equity installment    | 898                      | 122                                | 656                                   | 778                       | 19                | 932                         | 37                         | -                                     |
| Home equity line of credit | 433                      | 110                                | 224                                   | 334                       | 17                | 389                         | -                          | -                                     |
| Auto loans and leases      | -                        | -                                  | -                                     | -                         | -                 | 1                           | -                          | -                                     |
| Other                      | 32                       | 20                                 | 12                                    | 32                        | 18                | 47                          | -                          | -                                     |
| Residential:               |                          |                                    |                                       |                           |                   |                             |                            |                                       |
| Real Estate                | 1,641                    | 614                                | 900                                   | 1,514                     | 138               | 2,123                       | 39                         | -                                     |
| Construction               | -                        | -                                  | -                                     | -                         | -                 | 14                          | -                          | -                                     |
| Total                      | \$ 9,535                 | \$ 2,673                           | \$ 5,115                              | \$ 7,788                  | \$ 380            | \$ 12,843                   | \$ 115                     | \$ 39                                 |

| (dollars in thousands)  | Unpaid principal balance | Recorded investment with allowance | Recorded investment with no allowance | Total recorded investment | Related allowance | Average recorded investment | Interest income recognized | Cash basis interest income recognized |
|-------------------------|--------------------------|------------------------------------|---------------------------------------|---------------------------|-------------------|-----------------------------|----------------------------|---------------------------------------|
| December 31, 2012       |                          |                                    |                                       |                           |                   |                             |                            |                                       |
| Commercial & industrial | \$ 52                    | \$ 8                               | \$ 52                                 | \$ 60                     | \$ 4              | \$ 275                      | \$ 4                       | \$ -                                  |
| Commercial real estate: |                          |                                    |                                       |                           |                   |                             |                            |                                       |
| Non-owner occupied      | 2,431                    | 957                                | 1,420                                 | 2,377                     | 233               | 4,172                       | 152                        | 20                                    |
| Owner occupied          | 5,940                    | 4,500                              | 1,099                                 | 5,599                     | 1,230             | 7,292                       | 121                        | -                                     |
| Construction            | 1,123                    | 210                                | 913                                   | 1,123                     | 194               | 941                         | -                          | -                                     |
| Consumer:               |                          |                                    |                                       |                           |                   |                             |                            |                                       |
| Home equity installment | 1,480                    | 524                                | 782                                   | 1,306                     | 38                | 1,023                       | -                          | -                                     |

|                            |           |          |          |           |          |           |        |       |
|----------------------------|-----------|----------|----------|-----------|----------|-----------|--------|-------|
| Home equity line of credit | 435       | 144      | 237      | 381       | 31       | 482       | -      | -     |
| Auto                       | -         | -        | -        | -         | -        | 1         | -      | -     |
| Other                      | 102       | 16       | 32       | 48        | 8        | 36        | -      | -     |
| Residential:               |           |          |          |           |          |           |        |       |
| Real Estate                | 2,688     | 564      | 1,766    | 2,330     | 76       | 2,342     | 17     | -     |
| Construction               | -         | -        | -        | -         | -        | 44        | -      | -     |
| Total                      | \$ 14,251 | \$ 6,923 | \$ 6,301 | \$ 13,224 | \$ 1,814 | \$ 16,608 | \$ 294 | \$ 20 |

## Credit Quality Indicators

### Commercial and industrial and commercial real estate

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

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

#### Pass

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

#### Special Mention

Loans in this category are graded a six and may be protected but are potentially weak. They constitute a credit risk to the

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

#### Substandard

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

#### Doubtful

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

#### Consumer and Residential

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

The following table presents loans, segregated by class, categorized into the appropriate credit quality indicator category as of the period indicated:

#### Commercial credit exposure

#### Credit risk profile by creditworthiness category

|                        | Commercial and industrial |            | Commercial real estate non-owner occupied |            | Commercial real estate owner occupied |            | Commercial real estate construction |            |
|------------------------|---------------------------|------------|---|------------|---------------------------------------|------------|-------------------------------------|------------|
|                        | 6/30/2013                 | 12/31/2012 | 6/30/2013                                 | 12/31/2012 | 6/30/2013                             | 12/31/2012 | 6/30/2013                           | 12/31/2012 |
| (dollars in thousands) |                           |            |   |            |                                       |            |                                     |            |
| Pass                   | \$ 68,373                 | \$ 61,821  | \$ 81,343                                 | \$ 72,738  | \$ 76,624                             | \$ 73,922  | \$ 7,844                            | \$ 8,094   |

Edgar Filing: FIDELITY D & D BANCORP INC - Form 10-Q

|                 |           |           |           |           |           |           |           |           |
|-----------------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|
| Special mention | 2,388     | 2,221     | 3,838     | 3,520     | 206       | 222       | 1,453     | 1,422     |
| Substandard     | 591       | 1,068     | 5,122     | 5,740     | 2,717     | 6,365     | 910       | 1,163     |
| Doubtful        | -         | -         | -         | -         | -         | -         | -         | -         |
| Total           | \$ 71,352 | \$ 65,110 | \$ 90,303 | \$ 81,998 | \$ 79,547 | \$ 80,509 | \$ 10,207 | \$ 10,679 |

Consumer credit exposure

Credit risk profile based on payment activity

| (dollars in thousands) | Home equity installment |            | Home equity line of credit |            | Auto loans and leases |            | Other     |            |
|------------------------|-------------------------|------------|----------------------------|------------|-----------------------|------------|-----------|------------|
|                        | 6/30/2013               | 12/31/2012 | 6/30/2013                  | 12/31/2012 | 6/30/2013             | 12/31/2012 | 6/30/2013 | 12/31/2012 |
| Performing             | \$ 34,020               | \$ 31,503  | \$ 33,943                  | \$ 33,788  | \$ 19,161             | \$ 17,395  | \$ 5,328  | \$ 6,074   |
| Non-performing         | 803                     | 1,325      | 337                        | 381        | -                     | 16         | 32        | 65         |
| Total                  | \$ 34,823               | \$ 32,828  | \$ 34,280                  | \$ 34,169  | \$ 19,161             | \$ 17,411  | \$ 5,360  | \$ 6,139   |

Mortgage lending credit exposure

Credit risk profile based on payment activity

| (dollars in thousands) | Residential real estate |            | Residential construction |            |
|------------------------|-------------------------|------------|--------------------------|------------|
|                        | 6/30/2013               | 12/31/2012 | 6/30/2013                | 12/31/2012 |
| Performing             | \$ 103,735              | \$ 93,408  | \$ 9,253                 | \$ 7,948   |
| Non-performing         | 1,940                   | 3,357      | -                        | -          |
| Total                  | \$ 105,675              | \$ 96,765  | \$ 9,253                 | \$ 7,948   |





#### Allowance for loan losses

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

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

- § identification of specific impaired loans by loan category;
- § specific loans that are not impaired, but have an identified potential for loss;
- § calculation of specific allowances where required for the impaired loans based on collateral and other objective and quantifiable evidence;
- § determination of loans with similar credit characteristics within each class of the loan portfolio segment and eliminating the impaired loans;
- § application of historical loss percentages (two-year average) to pools to determine the allowance allocation;
- § application of qualitative factor adjustment percentages to historical losses for trends or changes in the loan portfolio.
- § Qualitative factor adjustments include:
  - o levels of and trends in delinquencies and non-accrual loans;
  - o levels of and trends in charge-offs and recoveries;
  - o trends in volume and terms of loans;
  - o changes in risk selection and underwriting standards;
  - o changes in lending policies, procedures and practices;
  - o experience, ability and depth of lending management;
  - o national and local economic trends and conditions; and
  - o changes in credit concentrations.

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

Each quarter, management performs an assessment of the allowance for loan losses. The Company's Special Assets Committee meets quarterly and the applicable lenders discuss each relationship under review and reach a consensus on the appropriate estimated loss amount based on current accounting guidance. The Special Assets Committee's focus is on ensuring the pertinent facts are considered and the reserve amounts pursuant to the accounting principles are reasonable. The assessment process includes the review of all loans on a non-accruing basis as well as a review of certain loans to which the lenders or the Company's Credit Administration function have assigned a criticized or classified risk rating. In 2013, the Company did not change its policy or methodology in calculating the allowance for loan losses from the policy or methodology used in 2012.

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

20

---

Edgar Filing: FIDELITY D & D BANCORP INC - Form 10-Q

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

As of and for the six months ended June 30, 2013

| (dollars in thousands)                                | Commercial & industrial | Commercial real estate | Consumer  | Residential real estate | Unallocated | Total      |
|---|-------------------------|------------------------|-----------|-------------------------|-------------|------------|
| Allowance for Loan Losses:                            |                         |                        |           |                         |             |            |
| Beginning balance                                     | \$ 922                  | \$ 4,908               | \$ 1,639  | \$ 1,503                | \$ -        | \$ 8,972   |
| Charge-offs   | 48                      | 1,627                  | 180       | 64                      | -           | 1,919      |
| Recoveries  | 6                       | 12                     | 75        | -                       | -           | 93         |
| Provision   | 39                      | 228                    | 113       | 279                     | 491         | 1,150      |
| Ending balance  | \$ 919                  | \$ 3,521               | \$ 1,647  | \$ 1,718                | \$ 491      | \$ 8,296   |
| Ending balance: individually evaluated for impairment | \$ -                    | \$ 188                 | \$ 54     | \$ 138                  |             | \$ 380     |
| Ending balance: collectively evaluated for impairment | \$ 919                  | \$ 3,333               | \$ 1,593  | \$ 1,580                |             | \$ 7,425   |
| Loans Receivables:                                    |                         |                        |           |                         |             |            |
| Ending balance  | \$ 71,352               | \$ 180,057             | \$ 93,624 | \$ 114,928              |             | \$ 459,961 |
| Ending balance: individually evaluated for impairment | \$ 49                   | \$ 5,081               | \$ 1,144  | \$ 1,514                |             | \$ 7,788   |
| Ending balance: collectively evaluated for impairment | \$ 71,303               | \$ 174,976             | \$ 92,480 | \$ 113,414              |             | \$ 452,173 |

As of and for the three months ended June 30, 2013

| (dollars in thousands)     | Commercial & industrial | Commercial real estate | Consumer | Residential real estate | Unallocated | Total    |
|----------------------------|-------------------------|------------------------|----------|-------------------------|-------------|----------|
| Allowance for Loan Losses: |                         |                        |          |                         |             |          |
| Beginning balance          | \$ 854                  | \$ 3,729               | \$ 1,581 | \$ 1,658                | \$ 414      | \$ 8,236 |
| Charge-offs                | 4                       | 383                    | 142      | 25                      | -           | 554      |
| Recoveries                 | 2                       | 9                      | 3        | -                       | -           | 14       |
| Provision                  | 67                      | 166                    | 205      | 85                      | 77          | 600      |
| Ending balance             | \$ 919                  | \$ 3,521               | \$ 1,647 | \$ 1,718                | \$ 491      | \$ 8,296 |

As of and for the year ended December  
31, 2012

| (dollars in thousands)                                   | Commercial<br>&<br>industrial | Commercial<br>real estate | Consumer  | Residential<br>real estate | Unallocated | Total      |
|--|-------------------------------|---------------------------|-----------|----------------------------|-------------|------------|
| Allowance for Loan Losses:                               |                               |                           |           |                            |             |            |
| Beginning balance  | \$ 1,221                      | \$ 3,979                  | \$ 1,435  | \$ 1,051                   | \$ 422      | \$ 8,108   |
| Charge-offs  | 185                           | 1,335                     | 737       | 231                        | -           | 2,488      |
| Recoveries   | 26                            | 46                        | 30        | -                          | -           | 102        |
| Provision  | (140)                         | 2,218                     | 911       | 683                        | (422)       | 3,250      |
| Ending balance   | \$ 922                        | \$ 4,908                  | \$ 1,639  | \$ 1,503                   | \$ -        | \$ 8,972   |
| Ending balance: individually<br>evaluated for impairment | \$ 4                          | \$ 1,657                  | \$ 77     | \$ 76                      |             | \$ 1,814   |
| Ending balance: collectively<br>evaluated for impairment | \$ 918                        | \$ 3,251                  | \$ 1,562  | \$ 1,427                   |             | \$ 7,158   |
| Loans Receivables:                                       |                               |                           |           |                            |             |            |
| Ending balance   | \$ 65,110                     | \$ 173,186                | \$ 90,547 | \$ 104,713                 |             | \$ 433,556 |
| Ending balance: individually<br>evaluated for impairment | \$ 60                         | \$ 9,099                  | \$ 1,735  | \$ 2,330                   |             | \$ 13,224  |
| Ending balance: collectively<br>evaluated for impairment | \$ 65,050                     | \$ 164,087                | \$ 88,812 | \$ 102,383                 |             | \$ 420,332 |

21

---

Edgar Filing: FIDELITY D & D BANCORP INC - Form 10-Q

Information related to the change in the allowance for loan losses as of and for the three- and six- months ended June 30, 2012 is a follows:

As of and for the six months ended June 30, 2012

| (dollars in thousands)     | Commercial<br>&<br>industrial | Commercial<br>real estate | Consumer | Residential<br>real estate | Unallocated | Total    |
|----------------------------|-------------------------------|---------------------------|----------|----------------------------|-------------|----------|
| Allowance for Loan Losses: |                               |                           |          |                            |             |          |
| Beginning balance          | \$ 1,221                      | \$ 3,979                  | \$ 1,435 | \$ 1,051                   | \$ 422      | \$ 8,108 |
| Charge-offs                | 65                            | 739                       | 435      | 45                         | -           | 1,284    |
| Recoveries                 | 12                            | -                         | 15       | -                          | -           | 27       |
| Provision                  | 27                            | 903                       | 410      | 327                        | (367)       | 1,300    |
| Ending balance             | \$ 1,195                      | \$ 4,143                  | \$ 1,425 | \$ 1,333                   | \$ 55       | \$ 8,151 |

As of and for the three months ended June 30, 2012

| (dollars in thousands)     | Commercial<br>&<br>industrial | Commercial<br>real estate | Consumer | Residential<br>real estate | Unallocated | Total    |
|----------------------------|-------------------------------|---------------------------|----------|----------------------------|-------------|----------|
| Allowance for Loan Losses: |                               |                           |          |                            |             |          |
| Beginning balance          | \$ 1,206                      | \$ 4,041                  | \$ 1,453 | \$ 1,198                   | \$ 422      | \$ 8,320 |
| Charge-offs                | 65                            | 464                       | 228      | 28                         | -           | 785      |
| Recoveries                 | 4                             | -                         | 12       | -                          | -           | 16       |
| Provision                  | 50                            | 566                       | 188      | 163                        | (367)       | 600      |
| Ending balance             | \$ 1,195                      | \$ 4,143                  | \$ 1,425 | \$ 1,333                   | \$ 55       | \$ 8,151 |

## 6. Earnings per share

Basic earnings per share (EPS) is computed by dividing net income available to common shareholders by the weighted-average number of common shares outstanding for the period. Diluted EPS is computed in the same manner as basic EPS but also reflects the potential dilution that could occur from the grant of stock-based compensation awards. The Company maintains two active share-based compensation plans that may generate additional potentially dilutive common shares. For granted and unexercised stock options, dilution would occur if Company-issued stock options were exercised and converted into common stock. Since the average share market prices of the Company's common stock, during the three- and six- months ended June 30, 2013 and 2012, were below the strike prices of all unexercised outstanding options, there were no potentially dilutive shares outstanding in any of the reportable periods

related to stock options. For restricted stock, dilution would occur from the Company's unvested shares. There were 14,000 and 151 unvested restricted share grants outstanding as of June 30, 2013 and 2012, respectively.

In the computation of diluted EPS, the Company uses the treasury stock method to determine the dilutive effect of its granted but unexercised stock options and unvested restricted stock. Under the treasury stock method, the assumed proceeds, as defined, received from shares issued in a hypothetical stock option exercise or restricted stock grant, are assumed to be used to purchase treasury stock. Proceeds include: amounts received from the exercise of outstanding stock options; compensation cost for future service that the Company has not yet recognized in earnings; and any windfall tax benefits that would be credited directly to shareholders' equity when the grant generates a tax deduction (or a reduction in proceeds if there is a charge to equity). The Company does not consider awards from share-based grants in the computation of basic EPS.

The following table illustrates the data used in computing basic and diluted EPS for the periods indicated:

|   | Three months ended<br>June 30, |           | Six months ended June<br>30, |           |
|---|--------------------------------|-----------|------------------------------|-----------|
|   | 2013                           | 2012      | 2013                         | 2012      |
| (dollars in thousands except per share data)                        |                                |           |                              |           |
| Basic EPS:  |                                |           |                              |           |
| Net income available to common shareholders                         | \$ 1,513                       | \$ 1,317  | \$ 2,907                     | \$ 2,574  |
| Weighted-average common shares outstanding                          | 2,345,763                      | 2,277,423 | 2,338,087                    | 2,269,402 |
| Basic EPS   | \$ 0.64                        | \$ 0.57   | \$ 1.24                      | \$ 1.13   |
| Diluted EPS:  |                                |           |                              |           |
| Net income available to common shareholders                         | \$ 1,513                       | \$ 1,317  | \$ 2,907                     | \$ 2,574  |
| Weighted-average common shares outstanding                          | 2,345,763                      | 2,277,423 | 2,338,087                    | 2,269,402 |
| Potentially dilutive common shares                                  | 2,932                          | 151       | 4,172                        | 151       |
| Weighted-average common and potentially dilutive shares outstanding | 2,348,695                      | 2,277,574 | 2,342,259                    | 2,269,553 |
| Diluted EPS   | \$ 0.64                        | \$ 0.57   | \$ 1.24                      | \$ 1.13   |

## 7. Stock plans

The Company has two stock-based compensation plans (the stock compensation plans) from which it can grant stock-based compensation awards, and applies the fair value method of accounting for stock-based compensation provided under current accounting guidance. The guidelines require the cost of share-based payment transactions (including those with employees and non-employees) be recognized in the financial statements. The Company's stock compensation plans were shareholder-approved and permit the grant of share-based compensation awards to its employees and directors. The Company believes that the stock-based compensation plans will advance the development, growth and financial condition of the Company by providing incentives through participation in the appreciation in the value of the common stock of the Company to secure, retain and motivate the Company's employees and directors who are responsible for the operation and the management of the affairs of the Company, thereby aligning the interest of its employees and directors with the interest of its shareholders. In the stock compensation plans, employees and directors are eligible to be awarded stock-based compensation grants which can consist of stock options (qualified and non-qualified), stock appreciation rights (SARs) and restricted stock.

At the annual shareholders' meeting held on May 1, 2012, the shareholders of the Company approved and the Company adopted the 2012 Omnibus Stock Incentive Plan and the 2012 Director Stock Incentive Plan (collectively, the 2012 stock incentive plans). The 2012 stock incentive plans have replaced the 2000 Independent Directors Stock Option Plan and the 2000 Stock Incentive Plan (collectively, the 2000 stock incentive plans), both of which expired in 2011. Unless terminated by the Company's board of directors, the 2012 stock incentive plans shall expire on, and no options shall be granted after the tenth anniversary – or in the year 2022. Previously issued and currently outstanding options under the 2000 stock incentive plans may be exercised pursuant to the terms of the stock option plans existing at the time of grant. However, the outstanding options under the 2000 stock incentive plans may be cancelled and replaced with grants under the 2012 stock incentive plans.

In the 2012 Omnibus Stock Incentive Plan, the Company has reserved 500,000 shares of its no-par common stock for future issuance. In the Omnibus Stock Incentive Plan, 6,000 and 151 restricted stock awards were granted to employees during the first quarter of 2013 and the second quarter of 2012, respectively. In the 2012 grant, 134 of the 151 shares became fully vested during the second quarter of 2013 with the remaining 17 grants forfeited. The 2013 stock grants will vest over a period of four years. The Company recognizes share-based compensation expense over the requisite service or vesting period. Due to immateriality however, the entire expense, or \$2 thousand, from the 2012 grant was recognized on the date of grant.

In the 2012 Director Stock Incentive Plan, the Company has reserved 500,000 shares of its no-par common stock for issuance under the plan. In the Director Stock Incentive Plan, 8,000 restricted stock awards were granted to the members of the board of directors during the first quarter of 2013. The grants will vest over a period of two years. Share-based compensation expense is included as a component of salaries and employee benefits in the consolidated statements of income.

The following table summarizes the weighted-average fair value and vesting of restricted stock grants awarded during 2013 and 2012 under the 2012 stock incentive plans:

2013

2012



Edgar Filing: FIDELITY D & D BANCORP INC - Form 10-Q

|               | Shares  | Weighted-<br>average<br>grant<br>date fair<br>value | Vesting<br>period    | Shares  | Weighted-<br>average<br>grant<br>date fair<br>value | Vesting<br>period |
|---------------|---------|---|----------------------|---------|---|-------------------|
|               | granted |   |                      | granted |   |                   |
| Director plan | 8,000   | \$ 21.20  | 2 yrs - 50% per year | -       | \$ -  |                   |
| Omnibus plan  | 6,000   | 21.20   | 4 yrs - 25% per year | 151     | 21.50   | 1 year            |
| Total         | 14,000  | \$ 21.20  |                      | 151     | \$ 21.50  |                   |

23

---

Edgar Filing: FIDELITY D & D BANCORP INC - Form 10-Q

The following tables illustrate stock-based compensation expense recognized during the three- and six- months ended June 30, 2013 and 2012 and the unrecognized stock-based compensation expense as of June 30, 2013. There was no unrecognized stock-based compensation expense as of December 31, 2012:

| (dollars in thousands)                 | Three months ended June 30, |      | Six months ended June 30, |      |
|--|-----------------------------|------|---------------------------|------|
|  | 2013                        | 2012 | 2013                      | 2012 |
| Stock-based compensation expense:      |                             |      |                           |      |
| Director plan                          | \$ 21                       | \$ - | \$ 35                     | \$ - |
| Omnibus plan                           | 9                           | 2    | 14                        | 2    |
| Total stock-based compensation expense | \$ 30                       | \$ 2 | \$ 49                     | \$ 2 |

| (dollars in thousands)                              | As of June 30, 2013 |
|---|---------------------|
| Unrecognized stock-based compensation expense:      |                     |
| Director plan                                       | \$ 134              |
| Omnibus plan  | 114                 |
| Total unrecognized stock-based compensation expense | \$ 248              |

The unrecognized stock-based compensation expense as of June 30, 2013 will be recognized ratably over the periods ended January 2015 and January 2017 for the Director Plan and the Omnibus Plan, respectively.

For restricted stock, intrinsic value represents the closing price of the underlying stock at the end of the period. As of June 30, 2013, the intrinsic value of the Company's restricted stock under the Director and Omnibus plans was \$24.50 per share.

In addition to the 2012 stock incentive plans, the Company established the 2002 Employee Stock Purchase Plan (the ESPP) and reserved 110,000 shares of its un-issued capital stock for issuance under the plan. The ESPP was designed to promote broad-based employee ownership of the Company's stock and to motivate employees to improve job performance and enhance the financial results of the Company. Under the ESPP, participation is voluntary whereby employees use automatic payroll withholdings to purchase the Company's capital stock at a discounted price based on the fair market value of the capital stock as measured on either the commencement or termination dates, as defined. As of June 30, 2013, 29,956 shares have been issued under the ESPP. The ESPP is considered a compensatory plan and is required to comply with the provisions of current accounting guidance. Therefore, the Company recognizes compensation expense on its ESPP on the date the shares are purchased. For the six months ended June 30, 2013 and 2012, compensation expense related to the ESPP approximated \$10 thousand and \$12 thousand, respectively, and is included as a component of salaries and employee benefits in the consolidated statements of income. There was no compensation expense related to the ESPP for the three months ended June 30, 2013 and 2012.

## 8. Fair value measurements

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

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

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

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

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

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

Edgar Filing: FIDELITY D & D BANCORP INC - Form 10-Q

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

June 30, 2013

| (dollars in thousands)        | Carrying amount | Estimated fair value | Quoted prices in active markets (Level 1) | Significant other observable inputs (Level 2) | Significant other unobservable inputs (Level 3) |
|-------------------------------|-----------------|----------------------|---|---|---|
| Financial assets:             |                 |                      |   |   |   |
| Cash and cash equivalents     | \$ 15,266       | \$ 15,266            | \$ 15,266                                 | \$ -  | \$ -  |
| Held-to-maturity securities   | 207             | 227                  | -   | 227   | -   |
| Available-for-sale securities | 96,259          | 96,259               | 496                                       | 93,640  | 2,123   |
| FHLB Stock                    | 3,214           | 3,214                | -   | 3,214   | -   |
| Loans and leases, net         | 451,665         | 452,158              | -   | -   | 452,158   |
| Loans held-for-sale           | 5,389           | 5,417                | -   | 5,417   | -   |
| Accrued interest              | 2,073           | 2,073                | -   | 2,073   | -   |
| Financial liabilities:        |                 |                      |   |   |   |
| Deposit liabilities           | 519,523         | 519,968              | -   | 519,968                                       | -   |
| Short-term borrowings         | 16,199          | 16,199               | -   | 16,199  | -   |
| Long-term debt                | 16,000          | 18,195               | -   | 18,195  | -   |
| Accrued interest              | 200             | 200                  | -   | 200   | -   |

December 31, 2012

| (dollars in thousands)        | Carrying amount | Estimated fair value | Quoted prices in active markets (Level 1) | Significant other observable inputs (Level 2) | Significant other unobservable inputs (Level 3) |
|-------------------------------|-----------------|----------------------|---|---|---|
| Financial assets:             |                 |                      |   |   |   |
| Cash and cash equivalents     | \$ 21,846       | \$ 21,846            | \$ 21,846                                 | \$ -  | \$ -  |
| Held-to-maturity securities   | 289             | 320                  | -   | 320   | -   |
| Available-for-sale securities | 100,441         | 100,441              | 466                                       | 98,150  | 1,825   |
| FHLB Stock                    | 2,624           | 2,624                | -   | 2,624   | -   |
| Loans, net                    | 424,584         | 430,861              | -   | -   | 430,861   |
| Loans held-for-sale           | 10,545          | 10,824               | -   | 10,824  | -   |
| Accrued interest              | 1,985           | 1,985                | -   | 1,985   | -   |

Financial liabilities:

|                       |         |         |   |         |   |
|-----------------------|---------|---------|---|---------|---|
| Deposit liabilities   | 514,660 | 515,869 | - | 515,869 | - |
| Short-term borrowings | 8,056   | 8,056   | - | 8,056   | - |
| Long-term debt        | 16,000  | 18,691  | - | 18,691  | - |
| Accrued interest      | 195     | 195     | - | 195     | - |

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

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

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

FHLB stock: The Company considers the fair value of FHLB stock is equal to its carrying value or cost since there is no market value available and investments in and transactions for the stock are restricted and limited to the FHLB and its member-banks.

Loans: The fair value of loans is estimated by the net present value of the future expected cash flows discounted at current offering rates for similar loans. Current offering rates consider, among other things, credit risk. The carrying value that fair value is compared to is net of the allowance for loan losses and since there is significant judgment included in evaluating credit quality, loans are classified within Level 3 of the fair value hierarchy.

Loans held-for-sale: The fair value of loans held-for-sale is estimated using rates currently offered for similar loans and is typically obtained from FNMA or the FHLB.

Certificates of deposit: The fair value of certificates of deposit is based on discounted cash flows using rates which approximate market rates for deposits of similar maturities.

Long-term debt: Fair value is estimated using the rates currently offered for similar borrowings.

The following tables illustrate the financial instruments measured at fair value on a recurring basis segregated by hierarchy fair value levels as of the period indicated:

|  | Total<br>carrying<br>value<br>June 30,<br>2013 | Quoted<br>prices<br>in active<br>markets<br>(Level<br>1) | Significant<br>other<br>observable<br>inputs<br>(Level 2) | Significant<br>other<br>unobservable<br>inputs<br>(Level 3) |
|--|--|--|---|---|
| (dollars in thousands)                           |  |  |   |   |
| Available-for-sale securities:                   |  |  |   |   |
| Agency - GSE                                     | \$ 13,178                                      | \$ -   | \$ 13,178   | \$ -  |
| Obligations of states and political subdivisions | 32,541   | -  | 32,541  | -   |
| Corporate bonds:                                 |  |  |   |   |
| Pooled trust preferred securities                | 2,123  | -  | -   | 2,123   |
| MBS - GSE residential                            | 47,921   | -  | 47,921  | -   |
| Equity securities - financial services           | 496  | 496  | -   | -   |
| Total available-for-sale securities              | \$ 96,259                                      | \$ 496   | \$ 93,640   | \$ 2,123  |

|   | Total<br>carrying<br>value<br>December<br>31, 2012 | Quoted<br>prices<br>in active<br>markets<br>(Level<br>1) | Significant<br>other<br>observable<br>inputs<br>(Level 2) | Significant<br>other<br>unobservable<br>inputs<br>(Level 3) |
|---|--|--|---|---|
| (dollars in thousands)                              |  |  |   |   |
| Available-for-sale securities:                      |  |  |   |   |
| Agency - GSE  | \$ 17,740  | \$ -   | \$ 17,740   | \$ -  |
| Obligations of states and political<br>subdivisions | 29,857   | -  | 29,857  | -   |
| Corporate bonds:                                    |  |  |   |   |
| Pooled trust preferred securities                   | 1,825  | -  | -   | 1,825   |
| MBS - GSE residential                               | 50,553   | -  | 50,553  | -   |
| Equity securities - financial services              | 466  | 466  | -   | -   |
| Total available-for-sale securities                 | \$ 100,441   | \$ 466   | \$ 98,150   | \$ 1,825  |

Equity securities in the AFS portfolio are measured at fair value using quoted market prices for identical assets and are classified within Level 1 of the valuation hierarchy. Other than the Company's investment in corporate bonds, consisting of pooled trust preferred securities, other debt securities in the AFS portfolio are measured at fair value using market quotations provided by a third-party vendor, who is a provider of financial market data, analytics and related services to financial institutions. Assets classified as Level 2 use valuation techniques that are common to bond valuations. That is, in active markets whereby bonds of similar characteristics frequently trade, quotes for similar assets are obtained. For the six months ended June 30, 2013, there were no transfers to or from Level 1 and Level 2 fair value measurements for financial assets measured on a recurring basis.

The Company's pooled trust preferred securities include both observable and unobservable inputs to determine fair value and, therefore, are considered Level 3 inputs. The accounting pronouncement related to fair value measurement provides guidance on

estimating fair value when the volume and level of activity for an asset or liability have significantly decreased in relation to normal market activity such as is the case with the Company's investment in pooled trust preferred securities.

The following table presents and summarizes quantitative information about assets measured at fair value on a recurring basis whereby the Company uses Level 3 inputs to determine fair value:

Quantitative information about Level 3 fair value measurements as of the periods indicated:

|                                   | June 30, 2013 | December 31, 2012 | Unobservable input                 | June 30, 2013 Input utilized  | December 31, 2012 Input utilized |
|-----------------------------------|---------------|-------------------|------------------------------------|-------------------------------|----------------------------------|
| (dollars in thousands)            |               |                   |                                    |                               |                                  |
| Valuation technique               | Fair value    | Fair value        | Unobservable input                 | Input utilized                | Input utilized                   |
| Available-for-sale securities:    |               |                   |                                    |                               |                                  |
| Pooled trust preferred securities |               |                   |                                    |                               |                                  |
| discounted cash flow              | \$ 2,123      | \$ 1,825          | - structural behavior              | issuer specific 3.46% - 3.75% | issuer specific 4.11% - 4.17%    |
|                                   |               |                   | - estimated probability of default | 3.75%                         | 4.11% - 4.17%                    |
|                                   |               |                   | - correlation analysis among       |                               |                                  |
|                                   |               |                   | - issuers                          | 50% - 30%                     | 50% - 30%                        |
|                                   |               |                   | - loss given default rate          | 100%                          | 100%                             |
|                                   |               |                   | - prepayment rate                  | 0%                            | 0%                               |
|                                   |               |                   | - recovery rate                    | 0%                            | 0%                               |
|                                   |               |                   | - credit adjusted cash flow        |                               |                                  |
|                                   |               |                   | - discount rate                    | 0% - 42.5%                    | 0% - 36.3%                       |

The Company owns 13 issues of \$22.3 million, original par value, pooled trust preferred securities. As of June 30, 2013, the amortized cost and fair values amounted to \$6.2 million and \$2.1 million, respectively. The market for these securities is inactive – no new issues since 2007, financial institutions with less than \$10 billion in assets qualify for new issue Tier 1 capital treatment which further limits the already low probability of a new issue coming to market, trading is sparse and consummated mostly by speculative hedge funds. Observable pricing market inputs such as broker models, S&P pricing based on interpolated available market activity and Bloomberg fair value models for corporate issues are available, however, such inputs to be used as indicators of fair value would require significant adjustments. Therefore, management has determined that a fair value modeled income approach (discounted cash flow) is more representative of fair value than the market approach. This technique strives to maximize the use of observable inputs and minimizes the use of unobservable inputs. The Company uses the Moody's Wall Street Analytics methodology of valuation and analysis of collateralized "TruPS", and their proprietary software to help analyze and value the Company's pooled trust preferred securities portfolio. The major unobservable input assumptions used in the cash flow analysis include:

- Credit quality estimated using issuer specific probability of default;
- Correlation analysis or the potential for the tendency of companies to default once other companies in the same industry default: 50% for same industry and 30% for across industries;
- Loss given default or cash lost to investor. Assumed to be 100% with no recovery;
- Cash flows were forecast for the underlying collateral and applied to each tranche to determine the resulting distribution among securities, capturing the credit risk element of the collateral, and to determine the estimated



fundamental value of the security. No prepayments are assumed and the tranche coupon rate is used as the discount rate; and

- Finally, the orderly liquid exit values (OLEV) are calculated for valuation purposes. The OLEV estimates a new issuance spread as if the market was both liquid and active utilizing the current risk profile of the security and regression analysis across a large sample of tranches based on historical data. The discount rates determined on an overall basis ranged from 0% to 43% as of June 30, 2013 and are applied to the fundamental cash flow value (as determined above) of the security to determine fair value.

Edgar Filing: FIDELITY D & D BANCORP INC - Form 10-Q

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

| (dollars in thousands)            | As of and for the<br>six months ended<br>June 30, |          |
|-----------------------------------|---|----------|
|                                   | 2013  | 2012     |
| Balance at beginning of period    | \$ 1,825  | \$ 1,466 |
| Realized losses in earnings       | -   | (136)    |
| Unrealized gains (losses) in OCI: |   |          |
| Gains                             | 542   | 410      |
| Losses                            | (124)   | (108)    |
| Pay down / settlement             | (127)   | (47)     |
| Interest paid-in-kind             | 5   | 14       |
| Accretion                         | 2   | 2        |
| Balance at end of period          | \$ 2,123  | \$ 1,601 |

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

| (dollars in thousands)  | Total<br>carrying<br>value<br>at June<br>30, 2013 | Quoted   | Significant                                | Significant                                  |
|-------------------------|---|--|--|--|
|                         |   | prices in<br>active<br>markets<br>(Level<br>1) | other<br>observable<br>inputs<br>(Level 2) | other<br>unobservable<br>inputs<br>(Level 3) |
| Impaired loans          | \$ 2,293  | \$ -   | \$ -                                       | \$ 2,293                                     |
| Other real estate owned | 2,115   | -  | -  | 2,115  |
| Total                   | \$ 4,408  | \$ -   | \$ -                                       | \$ 4,408                                     |

| Total<br>carrying<br>value | Quoted                         | Significant                   | Significant                     |
|----------------------------|--------------------------------|-------------------------------|---------------------------------|
|                            | prices in<br>active<br>markets | other<br>observable<br>inputs | other<br>unobservable<br>inputs |

| (dollars in thousands)   | at                |           |           |           |
|--------------------------|-------------------|-----------|-----------|-----------|
|                          | December 31, 2012 | (Level 1) | (Level 2) | (Level 3) |
| Impaired loans           | \$ 5,109          | \$ -      | \$ -      | \$ 5,109  |
| Other real estate owned  | 1,448             | -         | -         | 1,448     |
| Other repossessed assets | 6                 | -         | -         | 6         |
| Total                    | \$ 6,563          | \$ -      | \$ -      | \$ 6,563  |

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

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

A loan is considered impaired when, based upon current information and events; it is probable that the Company will be unable to collect all scheduled payments in accordance with the contractual terms of the loan. Impaired loans that are collateral dependent are written down to fair value through the establishment of specific reserves, a component of the allowance for loan losses, and as such are carried at the lower of net recorded investment or the estimated fair value.

Estimates of fair value of the collateral are determined based on a variety of information, including available valuations from certified appraisers for similar assets, present value of discounted cash flows and inputs that are estimated based on commonly used and generally accepted industry liquidation advance rates and estimates and assumptions developed by management. Valuation techniques for impaired loans are generally determined through independent appraisals of the underlying collateral which generally include various Level 3 inputs which are not identifiable. These appraisals may be adjusted by management for estimated liquidation expenses and qualitative factors such as economic conditions. If real estate is not the primary source of repayment, present value of discounted cash flows and estimates using generally accepted industry liquidation advance rates are utilized. At June 30, 2013, the range of liquidation expenses and other appraisal adjustments of the impaired loans was -15.00% to -86.40% (weighted-average -30.91%). Due to the multitude of assumptions, many of which are subjective in nature, and the varying inputs and techniques used by appraisers, the Company recognizes that valuations could differ across a wide spectrum of techniques employed. Accordingly, fair value estimates for impaired loans are classified as Level 3.

For other real estate owned, fair value is generally determined through independent appraisals of the underlying properties which generally include various Level 3 inputs which are not identifiable. The appraisals may be adjusted by management for qualitative reasons and estimated liquidation expenses. Management's assumptions may include consideration of the location and occupancy of the property, along with current economic conditions. Subsequently, as these properties are actively marketed, the estimated fair values may be periodically adjusted through incremental subsequent write-downs. These write-downs usually reflect decreases in estimated values resulting from sales price observations as well as changing economic and market conditions. At June 30, 2013, adjustments to the appraisal values for other real estate owned ranged from -5.02% to -48.24% (weighted average -26.30%).

For repossessed assets, consisting of one automobile as of December 31, 2012, the Company refers to the National Automobile Dealers Association (NADA) guide to determine a vehicle's fair value. There were no other repossessed assets at June 30, 2013.

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

The following is management's discussion and analysis of the significant changes in the consolidated financial condition of the Company as of June 30, 2013 compared to December 31, 2012 and a comparison of the results of operations for the three- and six- months ended June 30, 2013 and 2012. Current performance may not be indicative of future results. This discussion should be read in conjunction with the Company's 2012 Annual Report filed on Form 10-K.

### Forward-looking statements

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

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

- § the effects of economic deterioration and the prolonged economic malaise on current customers, specifically the effect of the economy on loan customers' ability to repay loans;
- § the costs and effects of litigation and of unexpected or adverse outcomes in such litigation;
- § the impact of new laws and regulations, including the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 and the regulations promulgated thereunder;
- § impacts of the new capital and liquidity requirements of the Basel III standards and other regulatory pronouncements, regulations and rules;
- § governmental monetary and fiscal policies, as well as legislative and regulatory changes;
- § the effect of changes in accounting policies and practices, as may be adopted by the regulatory agencies, as well as the Financial Accounting Standards Board and other accounting standard setters;
- § the risks of changes in interest rates on the level and composition of deposits, loan demand, and the values of loan collateral, securities and interest rate protection agreements, as well as interest rate risks;
- § the effects of competition from other commercial banks, thrifts, mortgage banking firms, consumer finance companies, credit unions, securities brokerage firms, insurance companies, money market and other mutual funds and other financial institutions operating in our market area and elsewhere, including institutions operating locally, regionally, nationally and internationally, together with such competitors offering banking products and services by mail, telephone, computer and the internet;
- § technological changes;

- § acquisitions and integration of acquired businesses;
- § the failure of assumptions underlying the establishment of reserves for loan losses and estimations of values of collateral and various financial assets and liabilities;
- § volatilities in the securities markets;
- § slow economic conditions;
- § acts of war or terrorism; and
- § disruption of credit and equity markets.

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

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

## General

Nationally, the unemployment rate declined slightly from 7.8% at December 31, 2012 to 7.6% at June 30, 2013, remaining at the lowest level in three years. While the unemployment rate has been declining nationally, the unemployment rate in the Scranton-Wilkes-Barre Metropolitan Statistical Area (local) still remains above national and state levels. According to the U.S. Bureau of Labor Statistics, the local unemployment rate at June 30, 2013 was 9.5%, a 0.1 percentage point increase from 9.4% at December 31, 2012 and down 0.3 percentage points from June 30, 2012. Local economists and state labor analysts predict that unemployment rates will decline as the national economy improves. However, this economic improvement is anticipated to be slow-moving. As home prices surge nationally, local home prices remain sluggish. There are two major reasons that home prices in the local market are trailing the national improvement. The number of foreclosures has been declining on a national level, but was up nearly 55% in our local metropolitan area in the first quarter of 2013. Another issue that disproportionately impacts this region is the national rise in home prices has been driven by many markets that suffered mightily during the recession that are climbing up from historic lows. Pennsylvania did not experience the dysfunctional bubble other markets experienced such as in coastal and sunbelt regions. This region did not have the bubble or a significant price collapse so the recovery could be shorter, but with smaller steps. Notwithstanding these issues, high levels of unemployment and the prolonged weakness in the local housing and real estate markets may negatively impact the performance and condition of the Company's loan portfolios.

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

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

## Comparison of the results of operations

Three- and six- months ended June 30, 2013 and 2012

### Overview

Net income for the second quarter of 2013 increased \$0.2 million, or 15%, to \$1.5 million or \$0.64 per diluted share, compared to \$1.3 million or \$0.57 per diluted share in the same 2012 quarter. For the six months ended June 30, 2013, net income increased \$0.3 million, or 13%, to \$2.9 million or \$1.24 per diluted share, compared to \$2.6 million, or \$1.13 per diluted share, recorded for the six months ended June 30, 2012. In the quarterly comparison, net income increased \$0.2 million due to an increase in non-interest fee related income, a marginal increase in net interest income and a decline in non-interest expense. Similarly, net income in the year-to-date comparison increased due to higher

net interest and non-interest income and also included a lower provision for loan loss requirement. Other non-interest expense was essentially flat in the first half of the current year compared to the same period in 2012.

Return on average assets (ROA) and return on average shareholders' equity (ROE) were 1.00% and 9.98%, respectively, for the three months ended June 30, 2013 compared to 0.87% and 9.47%, respectively, for the three months ended June 30, 2012. For the six months ended June 30, 2013, ROA and ROE were 0.96% and 9.74%, respectively, compared to 0.85% and 9.35% for the same period in 2012. The improvement in ROA and ROE in both the three- and six- month comparisons was caused predominantly by the increase in net income.

#### Net interest income and interest sensitive assets / liabilities

Net interest income increased \$27 thousand, or 0.5%, in the second quarter of 2013 to \$5.2 million, from \$5.1 million recorded in the second quarter of 2012. The net interest rate spread improved three basis points to 3.67% for the three months ended June 30, 2013 from 3.64% for the three months ended June 30, 2012. During the same period, the net interest margin increased to 3.84% from 3.81%. The rise in net interest income, spread and margin was due primarily to shifting of interest-earning assets from the relatively lower yielding investment securities portfolio to the higher yielding loan portfolio – the average interest-bearing cash and securities portfolios declining \$36.8 million while the average balances of the loan portfolio increased by approximately \$33.8 million. The yield on most interest-earning assets declined from the second quarter of 2012 to the second quarter of 2013, more than offsetting the positive effect of the shift in earning asset volumes. However, the decline in

rates paid on interest-earning liabilities in conjunction with a \$13.0 million increase in average non-interest bearing demand deposits helped offset the negative impact lower rates had on the interest-earning asset portfolio.

Net interest income for the six months ended June 30, 2013 increased \$0.1 million, or 1%, from \$10.3 million in the first half of 2012 to \$10.4 million in the first half of 2013. During the same period, interest rate spread and margin each increased 7 basis points to 3.67% and 3.84%, respectively. Rates paid on interest-bearing liabilities declined 10 basis points and coupled with an increase in average non-interest bearing deposits of \$18.3 million more than offset the impact of a 3 basis point decline in the interest-earning asset portfolio. In addition, the Company shifted its emphasis from the lower yielding investment portfolio to higher yielding loans – particularly in the commercial real estate and residential mortgage loan portfolios where average loan volumes increased a total of \$34.5 million had helped boost interest income by \$0.2 million despite a decline in yield of 17 basis points in commercial loans and 47 basis points in residential mortgage loans.

The low interest rate environment caused yields from earning assets to further decline and will most likely continue to do so throughout 2013 and therefore may continue to constrict the Company's asset yields and possibly the net interest margin. At 70 basis points, the Company's cost of interest-bearing liabilities for the quarter ended June 30, 2013 is 7 basis points lower than the cost in the second quarter of 2012. Other than retaining maturing long-term CDs, reducing deposit rates further would have a minimal cost-saving effect. Recently, short to intermediate rates along the treasury yield curve had been slowly, but steadily rising and could, due to stiff competition, potentially pressure banks to increase deposit rates to prevent deposit outflow. The prime interest rate, the benchmark rate that banks use as a base rate for adjustable rate loans, is not expected to rise harmoniously along with the treasury yield curve thereby further pressuring net interest income should deposit market rates begin to steadily rise. To help combat the impending change to the economic landscape, the Company has successfully developed and will continue to strengthen its relationships with new and existing business customers by generating and retaining a higher level of average non-interest bearing DDA balances thereby reducing the Company's overall cost of funds. Strategically deploying these funds into interest earning-assets such as in the loan portfolio is an effective margin-enhancing strategy that the Company expects to continue to pursue and expand upon in 2013 to help stabilize net interest margin at acceptable levels.

The Company's Asset Liability Management (ALM) team meets regularly to discuss among other things, interest rate risk and when deemed necessary adjusts interest rates on deposits and repurchase agreements and to seek revenue enhancing strategies to combat the trend in declining interest income. The Company's marketing department, in concert with ALM, lenders and deposit gatherers, continues to develop prudent strategies that will grow the loan portfolio and accumulate low-cost deposits in order to contain the Company's interest rate margin.

The tables that follow set forth a comparison of average balances and their corresponding fully tax-equivalent (FTE) interest income and expense and annualized tax-equivalent yield and cost for the periods indicated. Within each of the tables, interest income was adjusted to a tax-equivalent basis, using the corporate federal tax rate of 34%, to recognize the income from tax-exempt interest-earning assets as if the interest was taxable. This treatment allows a uniform comparison between yields on interest-earning assets. Loans include loans HFS and non-accrual loans but exclude the allowance for loan losses. Net deferred loan cost amortization of \$72.2 thousand and \$42.9 thousand for the second quarters of 2013 and 2012, respectively, and \$0.1 million and \$59.6 thousand for the first halves of 2013 and 2012, respectively, are included in interest income from loans. Securities include non-accrual securities. Average balances are based on amortized cost and do not reflect net unrealized gains or losses. Net interest margin is calculated by dividing annualized net interest income by total average interest-earning assets. Cost of funds includes the effect of average non-interest bearing deposits as a funding source:





| (dollars in thousands)               | Three months ended |          |         | June 30, 2012   |          |         |
|--------------------------------------|--------------------|----------|---------|-----------------|----------|---------|
|                                      | June 30, 2013      |          | Yield / | June 30, 2012   |          | Yield / |
| Assets                               | Average balance    | Interest | rate    | Average balance | Interest | rate    |
| Interest-earning assets              |                    |          |         |                 |          |         |
| Interest-bearing deposits            | \$ 2,463           | \$ 2     | 0.31 %  | \$ 21,897       | \$ 14    | 0.25 %  |
| Investments:                         |                    |          |         |                 |          |         |
| Agency - GSE                         | 15,190             | 13       | 0.34    | 27,569          | 77       | 1.12    |
| MBS - GSE residential                | 48,233             | 123      | 1.03    | 53,280          | 163      | 1.23    |
| State and municipal                  | 29,516             | 459      | 6.23    | 28,412          | 466      | 6.59    |
| Other                                | 9,190              | 19       | 0.83    | 10,127          | 19       | 0.78    |
| Total investments                    | 102,129            | 614      | 2.44    | 119,388         | 725      | 2.44    |
| Loans and leases:                    |                    |          |         |                 |          |         |
| Commercial                           | 247,859            | 3,087    | 4.99    | 237,662         | 3,062    | 5.18    |
| Consumer                             | 57,522             | 876      | 6.11    | 56,797          | 953      | 6.74    |
| Residential real estate              | 153,642            | 1,556    | 4.06    | 130,768         | 1,455    | 4.47    |
| Total loans and leases               | 459,023            | 5,519    | 4.82    | 425,227         | 5,470    | 5.17    |
| Federal funds sold                   | 22                 | -        | 0.26    | 167             | -        | 0.26    |
| Total interest-earning assets        | 563,637            | 6,135    | 4.37 %  | 566,679         | 6,209    | 4.41 %  |
| Non-interest earning assets          | 45,215             |          |         | 41,369          |          |         |
| Total Assets                         | \$ 608,852         |          |         | \$ 608,048      |          |         |
| Liabilities and shareholders' equity |                    |          |         |                 |          |         |
| Interest-bearing liabilities         |                    |          |         |                 |          |         |
| Deposits:                            |                    |          |         |                 |          |         |
| Savings                              | \$ 109,414         | \$ 56    | 0.21 %  | \$ 108,339      | \$ 58    | 0.21 %  |
| Interest-bearing checking            | 80,110             | 19       | 0.10    | 83,231          | 31       | 0.15    |
| MMDA                                 | 80,736             | 105      | 0.52    | 97,272          | 125      | 0.52    |
| CDs < \$100,000                      | 76,912             | 200      | 1.04    | 79,091          | 247      | 1.26    |
| CDs > \$100,000                      | 41,355             | 130      | 1.26    | 41,289          | 156      | 1.52    |
| Clubs                                | 1,865              | 1        | 0.16    | 1,866           | 1        | 0.16    |
| Total interest-bearing deposits      | 390,392            | 511      | 0.52    | 411,088         | 618      | 0.60    |
| Repurchase agreements                | 8,807              | 4        | 0.18    | 11,952          | 7        | 0.25    |
| Borrowed funds                       | 22,392             | 217      | 3.89    | 16,002          | 213      | 5.35    |
| Total interest-bearing liabilities   | 421,591            | 732      | 0.70 %  | 439,042         | 838      | 0.77 %  |

Edgar Filing: FIDELITY D & D BANCORP INC - Form 10-Q

|  |            |            |
|--|------------|------------|
| Non-interest bearing deposits              | 122,805    | 109,785    |
| Non-interest bearing liabilities           | 3,657      | 3,266      |
| Total liabilities                          | 548,053    | 552,093    |
| Shareholders' equity                       | 60,799     | 55,955     |
| Total liabilities and shareholders' equity | \$ 608,852 | \$ 608,048 |
| Net interest income                        | \$ 5,403   | \$ 5,371   |
| Net interest spread                        | 3.67 %     | 3.64 %     |
| Net interest margin                        | 3.84 %     | 3.81 %     |
| Cost of funds                              | 0.54 %     | 0.61 %     |

32

---

| (dollars in thousands)               | Six months ended   |          |                 | June 30, 2012      |          |                 |
|--------------------------------------|--------------------|----------|-----------------|--------------------|----------|-----------------|
|                                      | June 30, 2013      |          | Yield /<br>rate | June 30, 2012      |          | Yield /<br>rate |
| Assets                               | Average<br>balance | Interest |                 | Average<br>balance | Interest |                 |
| Interest-earning assets              |                    |          |                 |                    |          |                 |
| Interest-bearing deposits            | \$ 9,900           | \$ 14    | 0.29 %          | \$ 33,331          | \$ 42    | 0.25 %          |
| Investments:                         |                    |          |                 |                    |          |                 |
| Agency - GSE                         | 16,325             | 58       | 0.71            | 26,841             | 153      | 1.14            |
| MBS - GSE residential                | 49,336             | 258      | 1.06            | 51,687             | 368      | 1.43            |
| State and municipal                  | 28,435             | 894      | 6.34            | 28,409             | 931      | 6.59            |
| Other                                | 9,125              | 39       | 0.86            | 10,299             | 40       | 0.77            |
| Total investments                    | 103,221            | 1,249    | 2.44            | 117,236            | 1,492    | 2.56            |
| Loans and leases:                    |                    |          |                 |                    |          |                 |
| Commercial                           | 244,827            | 6,110    | 5.03            | 236,647            | 6,143    | 5.22            |
| Consumer                             | 56,490             | 1,784    | 6.37            | 56,328             | 1,900    | 6.78            |
| Residential real estate              | 153,627            | 3,144    | 4.13            | 127,263            | 2,912    | 4.60            |
| Total loans and leases               | 454,944            | 11,038   | 4.89            | 420,238            | 10,955   | 5.24            |
| Federal funds sold                   | 231                | -        | 0.26            | 228                | -        | 0.25            |
| Total interest-earning assets        | 568,296            | 12,301   | 4.37 %          | 571,033            | 12,489   | 4.40 %          |
| Non-interest earning assets          | 45,083             |          |                 | 41,307             |          |                 |
| Total Assets                         | \$ 613,379         |          |                 | \$ 612,340         |          |                 |
| Liabilities and shareholders' equity |                    |          |                 |                    |          |                 |
| Interest-bearing liabilities         |                    |          |                 |                    |          |                 |
| Deposits:                            |                    |          |                 |                    |          |                 |
| Savings                              | \$ 109,146         | \$ 112   | 0.21 %          | \$ 108,562         | \$ 117   | 0.22 %          |
| Interest-bearing checking            | 81,631             | 46       | 0.11            | 80,168             | 54       | 0.13            |
| MMDA                                 | 80,640             | 209      | 0.52            | 101,444            | 275      | 0.55            |
| CDs < \$100,000                      | 75,899             | 398      | 1.06            | 80,603             | 529      | 1.32            |
| CDs > \$100,000                      | 41,313             | 260      | 1.27            | 41,249             | 325      | 1.58            |
| Clubs                                | 1,624              | 1        | 0.16            | 1,615              | 1        | 0.16            |
| Total interest-bearing deposits      | 390,253            | 1,026    | 0.53            | 413,641            | 1,301    | 0.63            |
| Repurchase agreements                | 13,068             | 13       | 0.20            | 13,994             | 23       | 0.32            |
| Borrowed funds                       | 19,333             | 428      | 4.46            | 17,542             | 452      | 5.18            |
| Total interest-bearing liabilities   | 422,654            | 1,467    | 0.70 %          | 445,177            | 1,776    | 0.80 %          |

Edgar Filing: FIDELITY D & D BANCORP INC - Form 10-Q

|  |            |            |
|--|------------|------------|
| Non-interest bearing deposits              | 126,812    | 108,480    |
| Non-interest bearing liabilities           | 3,734      | 3,310      |
| Total liabilities                          | 553,200    | 556,967    |
| Shareholders' equity                       | 60,179     | 55,373     |
| Total liabilities and shareholders' equity | \$ 613,379 | \$ 612,340 |
| Net interest income                        | \$ 10,834  | \$ 10,713  |
| Net interest spread                        | 3.67 %     | 3.60 %     |
| Net interest margin                        | 3.84 %     | 3.77 %     |
| Cost of funds                              | 0.54 %     | 0.64 %     |

33

---

#### Provision for loan losses

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

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

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

Provisions for loan losses of \$1.2 million were recorded for the first six months of 2013, compared to \$1.3 million during the first six months of 2012. Provisions for loan losses were \$0.6 million for the three months ending June 30, 2013, unchanged from the provisions recorded during the three months ending June 30, 2012. The Company's non-performing loans declined to \$7.7 million as of June 30, 2013, a \$6.0 million decrease from year-end 2012 and from the same period last year. However, the additional provision in the second quarter of 2013 was necessary to fund the allowance to support growth in the loan portfolio and to reinforce the allowance for the potential credit risks that still exist from an uncertain local economic climate. The allowance for loan losses was \$8.3 million as of June 30, 2013, compared to \$9.0 million for December 31, 2012. The decrease in the allowance reflects charge downs of a large commercial real estate loan and a commercial construction loan during the first and second quarters of 2013, respectively.

#### Other income

For the three months ended June 30, 2013, non-interest income amounted to \$2.1 million, a \$0.2 million improvement, compared to \$1.9 million in the same 2012 quarter. The improvement in 2013 was caused by fees generated from growth in deposits, interchange, trust and financial services. In addition, the Company did not incur credit related OTTI charges from impaired pooled trust preferred securities in the current year quarter compared to \$31 thousand of

credit related OTTI charges incurred during the second quarter of 2012. These items were partially offset by a \$44 thousand reduction from gains recognized from loan sales in the current year second quarter compared to the 2012 second quarter.

For the six months ended June 30, 2013, non-interest income amounted to \$4.1 million, an increase of \$0.2 million, or 6%, from \$3.9 million recorded in the first half of 2012. Additional fees from growth in services as noted in the quarter comparison and the absence of credit OTTI charges in the current year compared to \$0.1 million incurred in the prior year six month period helped boost non-interest revenue. A decline in consumer lending related fees was the cause fees on loans declined by \$69 thousand for the six months ended June 30, 2013 compared to the six months ended June 30, 2012. In addition, gains from the investment portfolios were \$0.1 million less in the first six months of 2013 compared to the six months ended June 30, 2012.

#### Other operating expenses

Other operating expenses decreased \$0.1 million, or 2%, from \$4.7 million in the second quarter of 2012 to \$4.6 million in the second quarter of 2013. Advertising and marketing expenses declined \$28 thousand, or 11%, in the second quarter of 2013 compared to the second quarter of 2012 due to the earlier than normal start of a sales campaign in 2013 that had traditionally begun during the second quarter. For the same period, ORE expenses decreased \$43 thousand, from \$0.1 million in 2012 to \$61 thousand in 2013. This reduction is related to the recording of several one-time expenses related to specific ORE properties in the second quarter 2012. These properties have subsequently been sold. The \$0.1 million, or 26%, decrease in the other expense category was caused mostly by lower training (more in-house training and less sales related and compliance training in the current year compared to 2012), the refund of tax resulting from the favorable outcome a state sales tax appeal, and the non-recurring nature of an expense incurred in the second quarter of 2012 to reacquire a previously sold loan from the FNMA. Salary and employee benefits increased \$0.1 million, or 6%, due to normal salary merit increases, two additional full-time equivalents (FTEs), (including the hiring of a chief operating officer in the third quarter of 2012), the related employee benefits and higher amounts of employee incentive related costs.

For the six months ended June 30, 2013, other operating expenses increased \$27 thousand compared to the six months ended June 30, 2012. Salary and employee benefits increased \$0.2 million, or 5%, due to a larger work force and higher amounts of employee incentive related costs. Advertising and marketing expenses increased \$72 thousand, or 18%, during the six months ended June 30, 2013 compared to the same period in 2012 because the Company launched several marketing activities including a new branding and sales campaign designed to increase retail and business household acquisitions. The decrease in professional services of \$94 thousand was due to less need and therefore lower legal services related expenses, non-recurring 2012 SBA examination fees and other lower ancillary professional service costs. The \$0.2 million, or 22%, decrease in the other expense category was caused mostly by a non-recurring prepayment fee of \$0.2 million from the payoff of the \$5.0 million, 3.61%, FHLB loan in the first quarter of 2012.

Comparison of financial condition at

June 30, 2013 and December 31, 2012

Overview

Consolidated assets increased \$13.7 million, or 2%, to \$615.2 million as of June 30, 2013 from \$601.5 million at December 31, 2012. The increase included growth in short-term borrowings of \$8.1 million, consisting mostly of overnight borrowings, deposits of \$4.9 million and a \$1.0 million increase in shareholders' equity, the latter from \$2.9 million of net income partially offset by \$0.6 million of dividends declared, net of activity in the Company's dividend reinvestment plan, and \$1.5 million in other comprehensive loss. The funding sources, cash flow from the investment portfolio and cash on hand were used to finance growth in the loan portfolio.

Funds Deployed:

Investment securities

At the time of purchase, management classifies investment securities into one of three categories: trading, available-for-sale (AFS) or held-to-maturity (HTM). To date, management has not purchased any securities for trading purposes. Most of the securities the Company purchases are classified as AFS even though there is no immediate intent to sell them. The AFS designation affords management the flexibility to sell securities and position the balance sheet in response to capital levels, liquidity needs or changes in market conditions. Securities AFS are carried at fair value in the consolidated balance sheet with an adjustment to shareholders' equity, net of tax, presented under the caption "Accumulated other comprehensive income (loss)." Securities designated as HTM are carried at amortized cost and represent debt securities that the Company has the ability and intent to hold until maturity.

As of June 30, 2013, the carrying value of investment securities amounted to \$96.5 million, or 16% of total assets, compared to \$100.7 million, or 17% of total assets, at December 31, 2012. On June 30, 2013, approximately 50% of the carrying value of the investment portfolio was comprised of U.S. Government Sponsored Enterprise residential mortgage-backed securities (MBS – GSE residential or mortgage-backed securities) that amortize and provide monthly cash flow that the Company can use for reinvestment, unexpected deposit outflow, facility expansion or operations.

As of June 30, 2013, investment securities were comprised of HTM and AFS securities with carrying values of \$0.2 million and \$96.3 million, respectively. The AFS debt and equity securities were recorded with a combined net unrealized loss in the amount of \$1.9 million as of June 30, 2013 compared to an unrealized gain of \$0.4 million as of December 31, 2012, respectively, or a net decline of \$2.3 million during the first half of 2013.



The Company's investment policy is designed to complement its lending activity. During the six months ended June 30, 2013, the carrying value of total investments decreased \$4.3 million, or 4%. With \$27.1 million of growth in the loan portfolio, currently offering better returns than can be obtained in the capital markets, growth in investments will be considered after loan demand, facility expansion and deposit outflow. The Company will however, maintain a diverse investment portfolio to help mitigate overall risk and maintain a strong balance sheet.

35

---

A comparison of investment securities at June 30, 2013 and December 31, 2012 is as follows:

| (dollars in thousands)                 | June 30, 2013 |         | December 31, 2012 |         |
|--|---------------|---------|-------------------|---------|
|  | Amount        | %       | Amount            | %       |
| MBS - GSE residential                  | \$ 48,128     | 49.9 %  | \$ 50,842         | 50.5 %  |
| State & municipal subdivisions         | 32,541        | 33.7    | 29,857            | 29.6    |
| Agency - GSE                           | 13,178        | 13.7    | 17,740            | 17.6    |
| Pooled trust preferred securities      | 2,123         | 2.2     | 1,825             | 1.8     |
| Equity securities - financial services | 496           | 0.5     | 466               | 0.5     |
| Total                                  | \$ 96,466     | 100.0 % | \$ 100,730        | 100.0 % |

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

The Company owns 13 tranches of pooled trust preferred securities (PreTSLs). As of June 30, 2013, the market for these securities and other issues of PreTSLs remained inactive. The inactivity was evidenced first by a significant widening of the bid-ask spread in the brokered markets in which PreTSLs trade, then by a significant decrease in the volume of trades relative to historical levels. There has not been a new PreTSL issue since 2007. Newly imposed restrictions for institutions to qualify and receive favorable capital treatment have lessened the likelihood of new issues coming to market. There are currently very few market participants who are willing and/or able to transact for these securities. The Company has determined that the volume of trading activity in PreTSLs is minor, restricted mostly to speculative hedge fund traders, transacted on a bid basis and can take as long as weeks to fill orders and for the transactions to settle. Therefore, the Company has concluded that the market for these securities is inactive where pricing quotes are sparse, incorporate large illiquidity premiums, and exist with dislocation between spreads and default activity resulting in difficulties in assessing relative observable market inputs to determine fair value. To determine PreTSL valuations, the Company uses an independent third party that employs Moody's Wall Street Analytics. Therefore, in lieu of a market-quote approach to determine fair value of the PreTSL portfolio, a fair value "Level 3" modeled income approach is utilized. The income approach maximizes the use of observable inputs and minimizes the use of unobservable inputs and is more representative of fair value than the market-quote approach in markets that are inactive. Core assumption categories are: probability of default; loss given defaults; industry-wide correlations, discount rate and structural behavior. Discounted cash flows are modeled via Monte Carlo simulation to

determine the orderly liquidation value as an indication of fair value of all tranches of each PreTSL.

For the six months ended June 30, 2013, the Company engaged a structured finance products specialist firm to analyze the seven securities (eight tranches) in the portfolio that have an amortized cost basis. The analysis establishes a base of fundamental cash flow values to determine whether the Company will receive all of its principal and interest. One security (PreTSL XXVII) was deemed to have a high probability of receiving all principal and interest payments and thus impairment was considered temporary. The firm applied the following steps and assumptions to the remaining six securities to arrive at a single best estimate of cash flow that is used as a basis to determine the presence of OTTI:

- o Data about the transaction structure, as defined in the offering indenture and the underlying collateral, was collected;
- o The credit quality of the collateral was estimated using issuer specific probability of default for each security. Deferral of interest payments are treated as defaults. Once an issuer defaults, the potential for the tendency is correlated among other issuers. The loss given default, or the amount of cash lost to the investor is assumed to be 100% with no recovery of principal and no prepayments;
- o The analysis uses a Monte Carlo simulation framework to simulate the time-to-default on a portfolio of obligors based on individual obligor default probabilities and inter-obligor correlations;

- o Cash flow modeling was performed using the output from the simulation engine to arrive at the single best estimate of cash flow for each tranche;
- o Present value techniques as prescribed in the accounting guidance are used to determine the expected cash flows of each of the tranches. The present value technique for one of the OTTI securities is based upon a discount rate determined at the time of acquisition. For the other six OTTI securities, the discount rate used in the present value calculation is the yield to accrete beneficial interest;
- o The present value results are then compared to the present value cash flow results from the immediately prior measurement date. An adverse change in estimated cash flow from the previous measurement date is indicative of credit related OTTI. If the present value of the cash flow is less than the amortized cost basis, the difference is charged to current earnings as an impairment loss on investment securities.

The results of the OTTI analysis (refer to Note 4, "Investment securities", within the notes to the consolidated financial statements for a description of the analysis performed) determined as of and for the six months ended June 30, 2013, the estimated value, based on the expected discounted cash flow, of all securities was sufficient to recover the amortized cost basis, and therefore no credit-related OTTI was needed for the three- and six- months ended June 30, 2013 compared to \$31 thousand and \$0.1 million for the three- and six- months ended June 30, 2012. Credit-related OTTI is charged to current earnings as a component of other income in the consolidated statements of income. Future analyses could yield results that may be indicative of further impairment and may therefore require additional write-downs and corresponding credit related OTTI charges to current earnings.

#### Federal Home Loan Bank Stock

Investment in FHLB stock is required for membership in the organization and is carried at cost since there is no market value available. The amount the Company is required to invest is dependent upon the relative size of outstanding borrowings the Company has with the FHLB of Pittsburgh. Excess stock is typically repurchased from the Company at par if the amount of borrowings decline to a predetermined level. In addition, the Company typically earns a return or dividend based on the amount invested. The \$0.6 million increase in FHLB stock as of June 30, 2013 compared to year-end 2012 was due to increased short-term borrowings.

#### Loans held-for-sale (HFS)

Upon origination, residential mortgages and certain small business administration (SBA) guaranteed loans may be classified as HFS. In the event of market rate increases, fixed-rate loans and loans not immediately scheduled to re-price would no longer produce yields consistent with the current market. In low interest rate environments, the Company would be exposed to prepayment risk and, as rates on adjustable-rate loans decrease, interest income would be negatively affected. Consideration is given to the Company's current liquidity position and projected future liquidity needs. To better manage prepayment and interest rate risk, loans that meet these conditions may be classified as HFS. The carrying value of loans HFS is at the lower of cost or estimated fair value. If the fair values of these loans decline below their original cost, the difference is written down and charged to current earnings. Subsequent appreciation in the portfolio is credited to current earnings but only to the extent of previous write-downs. As of June 30, 2013 and December 31, 2012, loans HFS consisted of residential mortgage loans.

As of June 30, 2013, loans HFS amounted to \$5.4 million which approximated fair value, compared to \$10.5 million and \$10.8 million, respectively, at December 31, 2012. During the six months ended June 30, 2013, residential mortgage loans with principal balances of \$50.2 million were sold into the secondary market and the Company recognized net gains of approximately \$0.8 million, compared to \$39.5 million and \$0.8 million, respectively during the six months ended June 30, 2012. Gains of \$41 thousand, deferred from sales of SBA loans in the fourth quarter of 2012, were recognized in the first quarter of 2013. There were no gains or losses recognized during the first half of 2012 from sales of SBA loans.

The Company retains mortgage servicing rights (MSRs) on loans sold into the secondary market. MSRs are retained so that the Company can foster personal relationships with its loyal customer base. At June 30, 2013 and December

31, 2012, the servicing portfolio balance of sold residential mortgage loans was \$229.4 million and \$214.7 million, respectively.

#### Loans and leases

The focus of our Company remains managing and expanding our existing relationships and developing new relationships as well as seeking referrals from centers of influence such as attorneys and accountants within our primary market. Our primary market for maintaining and originating loans continues to be in Lackawanna and Luzerne counties for commercial and industrial (C&I), commercial real estate (CRE), residential mortgages, consumer, home equity and construction loans. The volume of activity is in direct proportion to demand, and current and anticipated interest rate levels. Although our local economy does show signs of improvement, our strategy remains steadfast of being conservative while providing assistance to our customers and prospects as well as helping our local economy. We strive to keep risk exposure at a manageable level through loan participations (sharing loans with other financial institutions to reduce exposure), the utilization of various guaranty programs and adjusting our advance rate based upon perceived risk.

37

---

## Edgar Filing: FIDELITY D & D BANCORP INC - Form 10-Q

As a preferred lender under the Small Business Administration (SBA) we have opportunities to provide credit facilities to the business community, help the area grow and prosper while at the same time reducing credit risk to our Bank.

### Commercial and industrial

Comparing the commercial and industrial (C&I) loan portfolio at December 31, 2012 of \$65.1 million and \$71.3 million at June 30, 2013, there was an increase of \$6.2 million, or 10%. This increase is primarily the result of the efforts by branch personnel and small business lenders to maintain and expand relationships of our existing customers.

### Commercial real estate

The commercial real estate loan portfolio increased \$6.9 million, or 4%, from \$173.2 million at December 31, 2012 to \$180.1 million as of June 30, 2013. The portfolio level has increased overall and remains steady for the second quarter of 2013. The trend that has occurred during the second quarter should remain through year end. It is unlikely this category will experience much growth for the remainder of 2013.

### Consumer

The consumer loan portfolio increased by \$3.1 million, or 3%, from \$90.6 million at December 31, 2012 to \$93.7 million at June 30, 2013. The increase was primarily attributed to home equity installment loans which increased \$2.0 million, or 6%. This was followed closely by auto loans and leases with a \$1.8 million increase, or 10%, in the first half of 2013. Both of these increases are the result of significant business development efforts; a targeted loan campaign on the home equity installment side and a dedicated dealer center on the auto loan and lease side.

### Residential

The residential loan portfolio increased \$10.2 million, or 10%, from \$104.7 million at December 31, 2012 to \$114.9 million at June 30, 2013. The Company reintroduced a mortgage loan modification program with the focus on retaining mortgage loans with maturities of 10 years or less. The program attributed primarily to the increase in the residential loan portfolio in the first half of 2013.

The composition of the loan portfolio at June 30, 2013 and December 31, 2012, is summarized as follows:

| (dollars in thousands)     | June 30, 2013 |        | December 31, 2012 |        |
|----------------------------|---------------|--------|-------------------|--------|
|                            | Amount        | %      | Amount            | %      |
| Commercial and industrial  | \$ 71,352     | 15.5 % | \$ 65,110         | 15.0 % |
| Commercial real estate:    |               |        |                   |        |
| Non-owner occupied         | 90,303        | 19.6   | 81,998            | 18.9   |
| Owner occupied             | 79,547        | 17.3   | 80,509            | 18.6   |
| Construction               | 10,207        | 2.2    | 10,679            | 2.5    |
| Consumer:                  |               |        |                   |        |
| Home equity installment    | 34,823        | 7.6    | 32,828            | 7.6    |
| Home equity line of credit | 34,280        | 7.5    | 34,169            | 7.9    |

Edgar Filing: FIDELITY D & D BANCORP INC - Form 10-Q

|                           |            |         |            |         |
|---------------------------|------------|---------|------------|---------|
| Auto loans and leases     | 19,202     | 4.2     | 17,411     | 4.0     |
| Other                     | 5,360      | 1.2     | 6,139      | 1.4     |
| Residential:              |            |         |            |         |
| Real estate               | 105,675    | 22.9    | 96,765     | 22.3    |
| Construction              | 9,253      | 2.0     | 7,948      | 1.8     |
| Gross loans               | 460,002    | 100.0 % | 433,556    | 100.0 % |
| Less:                     |            |         |            |         |
| Allowance for loan losses | (8,296)    |         | (8,972)    |         |
| Unearned lease revenue    | (41)       |         | -          |         |
| Net loans                 | \$ 451,665 |         | \$ 424,584 |         |
| Loans held-for-sale       | \$ 5,389   |         | \$ 10,545  |         |

Allowance for loan losses

Management evaluates the credit quality of the Company's loan portfolio and performs a formal review of the adequacy of the allowance for loan losses (the allowance) on a quarterly basis. The allowance reflects management's best estimate of the amount of credit losses in the loan portfolio. Management's judgment is based on the evaluation of individual loans, past experience, the assessment of current economic conditions and other relevant factors including the amounts and timing of cash flows expected to be received on impaired loans. Those estimates may be susceptible to significant change. The provision for loan losses represents

the amount necessary to maintain an appropriate allowance. Loan losses are charged directly against the allowance when loans are deemed to be uncollectible. Recoveries from previously charged-off loans are added to the allowance when received.

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

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

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

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

Total net charge-offs for the six months ended June 30, 2013 were \$1.8 million compared to \$1.3 million for the six months ended June 30, 2012. The increase is primarily related to commercial real estate net charge-offs of \$1.6 million during the first half of 2013, compared to \$0.7 million for the same period in 2012. This increase was mostly due to the charge down of one owner-occupied commercial real estate non-accrual loan. The loan carried a specific reserve as of December 31, 2012 based on the estimated net realizable value of the loan's collateral. The collateral was sold on May 10, 2013 and no additional material charge offs or expenses were incurred. For a discussion on the



provision for loan losses, see the “Provision for loan losses,” located in the results of operations section of management’s discussion and analysis contained herein.

The allowance for loan losses was \$8.3 million as of June 30, 2013, compared to \$9.0 million at December 31, 2012. Management believes that the current balance in the allowance for loan losses is sufficient to withstand the identified potential credit quality issues that may arise and others unidentified but inherent to the portfolio. Potential problem loans are those where there is known information that leads management to believe repayment of principal and/or interest is in jeopardy and the loans are currently neither on non-accrual status nor past due 90 days or more. Given continuing sluggishness in the economy, along with pressure on property values, there could be additional instances which become identified in future periods that may require additional charge-offs and/or increases to the allowance.

39

---

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

| (dollars in thousands)   | As of and for<br>the<br>six months<br>ended<br>June 30, 2013 | As of and for<br>the<br>twelve<br>months ended<br>December 31,<br>2012 | As of and for<br>the six<br>months ended<br>June 30, 2012 |   |            |   |
|--|--|--|---|---|------------|---|
| Balance at beginning of period   | \$ 8,972   | \$ 8,108   | \$ 8,108  |   |            |   |
| Charge-offs:   |  |  |   |   |            |   |
| Commercial and industrial  | 48   | 185  | 65  |   |            |   |
| Commercial real estate   | 1,627  | 1,335  | 739   |   |            |   |
| Consumer   | 180  | 737  | 435   |   |            |   |
| Residential  | 64   | 231  | 45  |   |            |   |
| Total  | 1,919  | 2,488  | 1,284   |   |            |   |
| Recoveries:  |  |  |   |   |            |   |
| Commercial and industrial  | 6  | 26   | 12  |   |            |   |
| Commercial real estate   | 12   | 46   | -   |   |            |   |
| Consumer   | 75   | 30   | 15  |   |            |   |
| Residential  | -  | -  | -   |   |            |   |
| Total  | 93   | 102  | 27  |   |            |   |
| Net charge-offs  | 1,826  | 2,386  | 1,257   |   |            |   |
| Provision for loan losses  | 1,150  | 3,250  | 1,300   |   |            |   |
| Balance at end of period   | \$ 8,296   | \$ 8,972   | \$ 8,151  |   |            |   |
| Net charge-offs (annualized) to average total loans outstanding          | 0.80   | %  | 0.56  | % | 0.60       | % |
| Allowance for loan losses to net charge-offs (annualized)                | 2.27   | x  | 3.76  | x | 3.24       | x |
| Allowance for loan losses to total loans                                 | 1.78   | %  | 2.02  | % | 1.91       | % |
| Loans 30 - 89 days past due and accruing                                 | \$ 1,921   |  | \$ 2,920  |   | \$ 3,762   |   |
| Loans 90 days or more past due and accruing                              | \$ 993   |  | \$ 1,723  |   | \$ 207     |   |
| Non-accrual loans  | \$ 6,710   |  | \$ 12,121   |   | \$ 13,486  |   |
| Allowance for loan losses to loans 90 days or more past due and accruing | 8.35   | x  | 5.21  | x | 39.38      | x |
| Allowance for loan losses to non-accrual loans                           | 1.24   | x  | 0.74  | x | 0.60       | x |
| Allowance for loan losses to non-performing loans                        | 1.08   | x  | 0.65  | x | 0.60       | x |
| Average total loans  | \$ 454,944   |  | \$ 426,636  |   | \$ 420,238 |   |

The allowance for loan losses can generally absorb losses throughout the loan portfolio. However, in some instances an allocation is made for specific loans or groups of loans. Allocation of the allowance for loan losses for different categories of loans is based on the methodology used by the Company, as previously explained. The changes in the allocations from period-to-period are based upon year-end reviews of the loan portfolio.

#### Non-performing assets

The Company defines non-performing assets as accruing loans past due 90 days or more, non-accrual loans, troubled debt restructured loans (TDRs), other real estate owned (ORE), repossessed assets and non-accrual investment securities. As of June 30, 2013, non-performing assets represented 2.03% of total assets reduced from 2.94% at December 31, 2012, mainly resulting from the reduction of residential and commercial loans 90 days or more past due and accruing, coupled with a reduction in residential, consumer and commercial loans on non-accrual status.

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

residential real estate and residential mortgage loans are placed on non-accrual status at 120 days past due as to principal and interest, and unsecured consumer loans are charged-off when the loan is 90 days or more past due as to principal and interest. Uncollected interest income accrued on all loans placed on non-accrual is reversed and charged to interest income.

As of June 30, 2013, non-performing assets were comprised of loans past due 90 days or more and accruing, non-accruing commercial loans, non-accruing real estate loans, non-accrual consumer loans, troubled debt restructurings, non-accrual securities and ORE. Most of the loans are collateralized, thereby mitigating the Company's potential for loss. At June 30, 2013 and December 31, 2012, \$1.1 million of corporate bonds consisting of pooled trust preferred securities were on non-accrual status. For a further discussion on the Company's securities portfolio, see Note 4, "Investment securities", within the notes to the consolidated financial statements and the section entitled "Investments", contained within this management's discussion and analysis section.

Non-performing loans decreased from \$13.8 million on December 31, 2012 to \$7.7 million at June 30, 2013. Non-performing loans consist of loans over 90 days past due and accruing and non-accrual loans. As of year-end 2012, there were seventeen loans to sixteen unrelated borrowers aggregating \$1.7 million in the over 90 day category ranging from less than \$1 thousand to \$0.6 million. At June 30, 2013, the over 90 days past due portion was \$1.0 million and was comprised of seven loans to five unrelated borrowers, ranging from \$3 thousand to \$0.3 million. Of the seven loans past due over 90 days, three loans, aggregating \$0.4 million were residential mortgages to unrelated borrowers. In addition, three loans were secured commercial loans aggregating \$0.5 million. The Company seeks payments from all past due customers through an aggressive customer communication process and, although a payment was made on one of these loans after the quarter ended, the loan remained past due.

A past due loan will be placed on non-accrual at the 90-day point when it is deemed that a customer is non-responsive and uncooperative to collection efforts. At December 31, 2012, there were 65 loans to 57 unrelated borrowers ranging from less than \$1 thousand to \$3.2 million in the non-accrual category. At June 30, 2013, there were 50 loans to 42 unrelated borrowers ranging from less than \$1 thousand to \$1.0 million in the non-accrual category. The decrease in non-accrual loans during the six months ended June 30, 2013 was related to loans that were charged off, paid off, transferred to ORE or moved back to accrual status.

The Company, on a regular basis, reviews changes to loans to determine if they meet the definition of a TDR. TDRs arise when a borrower experiences financial difficulty and the Company grants a concession that it would not otherwise grant based on current underwriting standards in order to maximize the Company's recovery. TDRs aggregated \$2.1 at June 30, 2013, which was a slight decrease from the December 31, 2012 total of \$2.2 million.

The following tables set forth the activity in TDRs as and for the periods indicated:

As of and for the six months ended June 30, 2013

| (dollars in thousands)      | Accruing                                 |                           | Non-accruing              |          |
|-----------------------------|--|---------------------------|---------------------------|----------|
|                             | Commercial<br>& Commercial<br>industrial | Commercial<br>real estate | Commercial<br>real estate | Total    |
| Troubled Debt Restructures: |  |                           |                           |          |
| Beginning balance           | \$ 42                                    | \$ 1,061                  | \$ 1,066                  | \$ 2,169 |
| Pay downs / payoffs         | 2  | 23                        | 32                        | 57       |
| Ending balance              | \$ 40                                    | \$ 1,038                  | \$ 1,034                  | \$ 2,112 |

As of and for the year ended December 31, 2012

| (dollars in thousands)      | Accruing<br>Commercial<br>& Commercial<br>industrial real estate | Non-accruing<br>Commercial<br>real estate | Total    |
|-----------------------------|--|---|----------|
| Troubled Debt Restructures: |  |   |          |
| Beginning balance           | \$ 44 \$ 5,270   | \$ 1,395                                  | \$ 6,709 |
| Pay downs / payoffs         | 2 4,998  | 129                                       | 5,129    |
| Advance on balance          | - 789  | -   | 789      |
| Charge offs                 | - -  | 200                                       | 200      |
| Ending balance              | \$ 42 \$ 1,061   | \$ 1,066                                  | \$ 2,169 |

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

new calendar year if the loan yields a market rate of interest.

At June 30, 2013, the non-accrual loans aggregated \$6.7 million as compared to \$12.1 million at December 31, 2012. The net decrease in the level of non-accrual loans during the period ending June 30, 2013 occurred as follows: additions to the non-accrual loan component of the non-performing assets totaling \$0.8 million were made during the period; these were offset by reductions or payoffs of \$2.9 million, charge-offs of \$1.8 million, \$1.1 million of transfers to ORE and \$0.4 million of loans that returned to performing status. Loans past due 90 days or more and accruing were \$1.0 million at June 30, 2013, compared to \$1.7 million as of December 31, 2012. The ratio of non-performing loans to total loans was 1.66% at June 30, 2013 compared to 3.12% at December 31, 2012.

Payments received from non-accrual loans are recognized on a cash method. Payments are first applied against the outstanding principal balance, then to the recovery of any charged-off loan amounts. Any excess is treated as a recovery of interest income. For the first six months of 2013, \$39 thousand in cash basis interest income was recognized. If the non-accrual loans that were outstanding as of June 30, 2013 had been performing in accordance with their original terms, the Company would have recognized interest income with respect to such loans of \$0.2 million during the six months ended June 30, 2013.

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

| (dollars in thousands)                         | June 30,<br>2013 | December 31, 2012 | June 30,<br>2012 |
|--|------------------|-------------------|------------------|
| Loans past due 90 days or more and accruing    | \$ 993           | \$ 1,723          | \$ 207           |
| Non-accrual loans *                            | 6,710            | 12,121            | 13,486           |
| Total non-performing loans                     | 7,703            | 13,844            | 13,693           |
| Troubled debt restructurings                   | 1,078            | 1,103             | 5,309            |
| Other real estate owned and repossessed assets | 2,617            | 1,607             | 2,086            |
| Non-accrual securities                         | 1,089            | 1,132             | 935              |
| Total non-performing assets                    | \$ 12,487        | \$ 17,686         | \$ 22,023        |
| <br>   |                  |                   |                  |
| Total loans, including loans held-for-sale     | \$ 465,350       | \$ 444,101        | \$ 426,118       |
| Total assets                                   | \$ 615,175       | \$ 601,525        | \$ 595,736       |
| Non-accrual loans to total loans               | 1.44%            | 2.73%             | 3.16%            |
| Non-performing loans to total loans            | 1.66%            | 3.12%             | 3.21%            |
| Non-performing assets to total assets          | 2.03%            | 2.94%             | 3.70%            |

\* In the table above, the amount includes non-accrual TDRs of \$1.0 million as of June 30, 2013 and \$1.1 million as of December 31, 2012 and June 30, 2012, respectively.

The composition of non-performing loans as of June 30, 2013 is as follows:

| Gross<br>loan | Past due<br>90 | Non-<br>accrual | Total non-<br>performing | % of<br>gross |
|---------------|----------------|-----------------|--------------------------|---------------|
|---------------|----------------|-----------------|--------------------------|---------------|

Edgar Filing: FIDELITY D & D BANCORP INC - Form 10-Q

| (dollars in thousands)     | balances   | days or<br>more<br>and still<br>accruing | loans    | loans    | loans |
|----------------------------|------------|--|----------|----------|-------|
| Commercial and industrial  | \$ 71,352  | \$ 224                                   | \$ 9     | \$ 233   | 0.33% |
| Commercial real estate:    |            |  |          |          |       |
| Non-owner occupied         | 90,303     | 275                                      | 1,698    | 1,973    | 2.18% |
| Owner occupied             | 79,547     | 40                                       | 1,488    | 1,528    | 1.92% |
| Construction               | 10,207     | -  | 857      | 857      | 8.40% |
| Consumer:                  |            |  |          |          |       |
| Home equity installment    | 34,823     | 25                                       | 778      | 803      | 2.31% |
| Home equity line of credit | 34,280     | 3  | 334      | 337      | 0.98% |
| Auto loans and leases      | 19,161     | -  | -        | -        | 0.00% |
| Other                      | 5,360      | -  | 32       | 32       | 0.60% |
| Residential:               |            |  |          |          |       |
| Real estate                | 105,675    | 426                                      | 1,514    | 1,940    | 1.84% |
| Construction               | 9,253      | -  | -        | -        | -     |
| Loans held-for-sale        | 5,389      | -  | -        | -        | -     |
| Total                      | \$ 465,350 | \$ 993                                   | \$ 6,710 | \$ 7,703 | 1.66% |

42

---

## Foreclosed assets held-for-sale

Foreclosed assets held-for-sale aggregated \$2.6 million at June 30, 2013 and \$1.6 million at December 31, 2012. The following table sets forth the activity in the ORE component of foreclosed assets held-for-sale:

| (dollars in thousands)         | June 30,    | December    |
|--------------------------------|-------------|-------------|
|                                | 2013        | 31, 2012    |
|                                | Amount #    | Amount #    |
| Balance at beginning of period | \$ 1,600 12 | \$ 1,169 6  |
| Additions                      | 1,420 9     | 1,778 14    |
| Pay downs                      | (5)         | (92)        |
| Write downs                    | (109)       | (86)        |
| Sold                           | (289) (3)   | (1,169)(8)  |
| Balance at end of period       | \$ 2,617 18 | \$ 1,600 12 |

As of December 31, 2012, the ORE balance consisted of: nine properties totaling \$0.8 million from 2012 additions; two properties aggregating \$0.2 million acquired in 2011 and one property acquired in 2010 for \$0.6 million. As of June 30, 2013, nine properties were added to ORE and three were sold, bringing the total to eighteen, which contributed an additional \$1.4 million to ORE for the first six months of 2013. Two of the properties that were sold were added to ORE in 2012 and the third was added in the first quarter of 2013. Of these nine properties added in the first six months of 2013, two were commercial real estate and seven were residential real estate. Of the eighteen ORE properties as of June 30, 2013, which stemmed from seventeen unrelated borrowers, twelve were listed for sale, two were pending listing with local realtors, two have signed sales agreements, one is being repaired and one is in litigation.

## Other assets

The increase in other assets of \$1.0 million, or 8%, consisted of a larger deferred tax asset principally from the \$2.3 million of unrealized losses recorded in the securities portfolio in the first half of 2013 and \$0.6 million for automobile lease residual values.

## Funds Provided:

## Deposits

The Company is a community based commercial depository financial institution, member FDIC, which offers a variety of deposit products with varying ranges of interest rates and terms. Deposit products include transaction accounts such as: savings; clubs; interest-bearing checking (NOW); money market and non-interest bearing checking (DDA). The Company also offers short- and long-term deposit accounts such as certificates of deposit. Certificates of deposit, or CDs, are deposits with stated maturities which can range from seven days to ten years. The flow of deposits is influenced by economic conditions, changes in the interest rate environment, pricing and competition. To determine interest rates on its deposit products, the Company considers local competition, spreads to earning-asset



yields, liquidity position and rates charged for alternative sources of funding such as short-term borrowings and FHLB advances.

The following table represents the components of deposits as of the date indicated:

| (dollars in thousands)    | June 30, 2013 |         | December 31, 2012 |         |
|---------------------------|---------------|---------|-------------------|---------|
|                           | Amount        | %       | Amount            | %       |
| Money market              | \$ 78,300     | 15.1 %  | \$ 76,571         | 14.9 %  |
| Interest-bearing checking | 84,228        | 16.2    | 87,981            | 17.1    |
| Savings and clubs         | 110,710       | 21.3    | 107,447           | 20.8    |
| Certificates of deposit   | 119,017       | 22.9    | 116,626           | 22.7    |
| Total interest-bearing    | 392,255       | 75.5    | 388,625           | 75.5    |
| Non-interest bearing      | 127,268       | 24.5    | 126,035           | 24.5    |
| Total deposits            | \$ 519,523    | 100.0 % | \$ 514,660        | 100.0 % |

Compared to December 31, 2012, total deposits increased \$4.9 million, or 1%, during the first half of 2013. With the exception of interest-bearing checking accounts, all other deposit product types registered marginal increases during 2013. Generally, deposits are obtained from consumers, businesses and public entities within the communities that surround the Company's 11 branch offices and all deposits are insured by the FDIC up to the full extent permitted by law.

Though the rates along the treasury yield curve have begun to slowly rise, the relatively low interest rate environment continues to cause business and retail customers to seek short-term alternatives for their deposits. Savings and clubs experienced a \$3.3 million increase as customers' preference is to park their cash in non-maturing, readily available deposit accounts. A promotional campaign focused on attracting and retaining certificates of deposit balances facilitated the \$2.4 million increase in CD's, while money market accounts were supported by depositors shifting balances with a \$1.7 million rise within the portfolio. The decrease in interest-bearing checking accounts was primarily the result of cash re-deployments and outflow of municipal deposits. The Company's focus continues to be on the acquisition and retention of retail and business households with a strong emphasis on deepening and broadening those relationships.

The Company uses the Certificate of Deposit Account Registry Service (CDARS) reciprocal program to obtain FDIC insurance protection for customers who have large deposits that at times may exceed the FDIC maximum amount of \$250,000. In the CDARS program, deposits with varying terms and interest rates, originated in the Company's own markets, are exchanged for deposits of other financial institutions that are members in the CDARS network. By placing these deposits in other participating institutions, the deposits of our customers are fully insured by the FDIC. In return for deposits placed with network institutions, the Company receives from network institutions deposits that are approximately equal in amount and are comprised of terms similar to those placed for our customers. Deposits the Company receives, or reciprocal deposits, from other institutions are considered brokered deposits by regulatory definitions. As of June 30, 2013 and December 31, 2012, CDARS represented \$11.8 million and \$10.2 million, respectively, or 2%, of total deposits.

Excluding CDARS, certificates of deposit accounts of \$100,000 or more amounted to \$41.6 million and \$41.8 million at June 30, 2013 and December 31, 2012, respectively. Certificates of deposit of \$250,000 or more amounted to \$15.4 million and \$16.2 million as of June 30, 2013 and December 31, 2012.

Including CDARS, approximately 33% of the CDs, with a weighted-average interest rate of 0.82%, are scheduled to mature in 2013 and an additional 31%, with a weighted-average interest rate of 1.06%, are scheduled to mature in 2014. Renewing CDs may re-price to lower or higher market rates depending on the rate on the maturing CD, the direction of interest rate movements, the shape of the yield curve, competition, the rate profile of the maturing accounts and depositor preference for alternative, non-term products. In this current low interest rate environment, a widespread preference has been for customers with maturing CDs to hold their deposits in readily available transaction accounts. Though the CD portfolio has increased since year-end 2012, prompted by the Company's CD promotion, when interest rates begin to steadily rise, the Company expects CDs to trend back toward historical levels.

### Borrowings

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

Repurchase agreements are non-insured interest-bearing liabilities that have a perfected security interest in qualified investments of the Company. The FDIC Depositor Protection Act of 2009 requires banks to provide a perfected security interest to the purchasers of uninsured repurchase agreements. Repurchase agreements are offered through a sweep product. A sweep account is designed to ensure that on a daily basis, an attached DDA is adequately funded and excess funds are transferred, or swept, into an interest-bearing overnight repurchase agreement account. Due to the constant inflow and outflow of funds of the sweep product, their balances tend to be somewhat volatile, similar to a DDA. Customer liquidity is the typical cause for variances in repurchase agreements, which during the first half of 2013 increased \$0.6 million, or 7%, from year-end December 31, 2012. In addition, short-term borrowings may include overnight balances which the Company may require to fund daily liquidity needs such as deposit and

Edgar Filing: FIDELITY D & D BANCORP INC - Form 10-Q

repurchase agreement cash outflow, loan demand and operations. At June 30, 2013, the Company had a balance of \$7.6 million in overnight borrowings. There were no overnight borrowings at December 31, 2012.

The following table represents the components of borrowings as of the date indicated:

| (dollars in thousands)                      | June 30, 2013 |         | December 31, 2012 |         |
|---|---------------|---------|-------------------|---------|
|   | Amount        | %       | Amount            | %       |
| Overnight borrowings                        | \$ 7,586      | 23.6 %  | \$ -              | - %     |
| Securities sold under repurchase agreements | 8,613         | 26.7    | 8,056             | 33.5    |
| Long-term FHLB advances                     | 16,000        | 49.7    | 16,000            | 66.5    |
| Total                                       | \$ 32,199     | 100.0 % | \$ 24,056         | 100.0 % |

### Item 3. Quantitative and Qualitative Disclosure About Market Risk

Management of interest rate risk and market risk analysis.

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

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

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

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

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

To manage this interest rate sensitivity gap position, an asset/liability model commonly known as cumulative gap analysis is used to monitor the difference in the volume of the Company's interest sensitive assets and liabilities that mature or re-price within given time intervals. A positive gap (asset sensitive) indicates that more assets will re-price during a given period compared to liabilities, while a negative gap (liability sensitive) has the opposite effect. The Company employs computerized net interest income simulation modeling to assist in quantifying interest rate risk exposure. This process measures and quantifies the impact on net interest income through varying interest rate changes and balance sheet compositions. The use of this model assists the ALCO to gauge the effects of the interest rate changes on interest-sensitive assets and liabilities in order to determine what impact these rate changes will have

upon the net interest spread. At June 30, 2013, the Company maintained a one-year cumulative gap of positive (asset sensitive) \$70.9 million, or 12%, of total assets. The effect of this positive gap position provided a mismatch of assets and liabilities which may expose the Company to interest rate risk during periods of falling interest rates. Conversely, in an increasing interest rate environment, net interest income could be positively impacted because more assets than liabilities will re-price upward during the one-year period.

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

The following table illustrates the Company's interest sensitivity gap position at June 30, 2013:

| (dollars in thousands)                                   | Three<br>months<br>or less | More than<br>three<br>months to<br>twelve<br>months | More than<br>one year<br>to three<br>years | More than<br>three years | Total      |
|--|----------------------------|---|--|--------------------------|------------|
| Cash and cash equivalents                                | \$ 48                      | \$ -  | \$ -                                       | \$ 15,218                | \$ 15,266  |
| Investment securities <sup>(1)(2)</sup>                  | 5,026                      | 13,199  | 26,153                                     | 55,302                   | 99,680     |
| Loans and leases <sup>(2)</sup>                          | 172,386                    | 66,836  | 113,973                                    | 103,859                  | 457,054    |
| Fixed and other assets                                   | -                          | 10,231  | -  | 32,944                   | 43,175     |
| Total assets   | \$ 177,460                 | \$ 90,266   | \$ 140,126                                 | \$ 207,323               | \$ 615,175 |
| Total cumulative assets                                  | \$ 177,460                 | \$ 267,726  | \$ 407,852                                 | \$ 615,175               |            |
| Non-interest-bearing transaction deposits <sup>(3)</sup> | \$ -                       | \$ 12,739   | \$ 34,973                                  | \$ 79,556                | \$ 127,268 |
| Interest-bearing transaction deposits <sup>(3)</sup>     | 89,798                     | 17,187  | 113,082                                    | 53,171                   | 273,238    |
| Certificates of deposit                                  | 15,451                     | 45,404  | 49,366                                     | 8,796                    | 119,017    |
| Repurchase agreements                                    | 8,613                      | -   | -  | -                        | 8,613      |
| Short-term borrowings                                    | 7,586                      | -   | -  | -                        | 7,586      |
| Long-term debt   | -                          | -   | -  | 16,000                   | 16,000     |
| Other liabilities  | -                          | -   | -  | 3,550                    | 3,550      |
| Total liabilities  | \$ 121,448                 | \$ 75,330   | \$ 197,421                                 | \$ 161,073               | \$ 555,272 |
| Total cumulative liabilities                             | \$ 121,448                 | \$ 196,778  | \$ 394,199                                 | \$ 555,272               |            |
| Interest sensitivity gap                                 | \$ 56,012                  | \$ 14,936   | \$ (57,295)                                | \$ 46,250                |            |
| Cumulative gap   | \$ 56,012                  | \$ 70,948   | \$ 13,653                                  | \$ 59,903                |            |
| Cumulative gap to total assets                           | 9.1%                       | 11.5%   | 2.2%                                       | 9.7%                     |            |

(1) Includes FHLB stock and the net unrealized gains/losses on available-for-sale securities.

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

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

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

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

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

The following table illustrates the simulated impact of an immediate 200 basis points upward or downward movement in interest rates on net interest income, net income and the change in the economic value (portfolio equity). This analysis assumed that interest-earning asset and interest-bearing liability levels at June 30, 2013 remained constant. The impact of the rate movements was developed by simulating the effect of the rate change over a twelve-month period from the June 30, 2013 levels:

|   | % change |          |
|---|----------|----------|
|   | Rates    | Rates    |
|   | +200     | -200     |
| Earnings at risk:                                     |          |          |
| Net interest income                                   | 5.1      | % (3.4)% |
| Net income  | 15.9     | (9.9)    |
| Economic value at risk:                               |          |          |
| Economic value of equity                              | (13.9)   | (8.6)    |
| Economic value of equity as a percent of total assets | (1.5)    | (0.9)    |

Economic value has the most meaning when viewed within the context of risk-based capital. Therefore, the economic value may normally change beyond the Company's policy guideline for a short period of time as long as the risk-based capital ratio (after adjusting for the excess equity exposure) is greater than 10%. At June 30, 2013, the Company's risk-based capital ratio was 13.7%.

The table below summarizes estimated changes in net interest income over a twelve-month period beginning July 1, 2013, under alternate interest rate scenarios using the income simulation model described above:

| (dollars in thousands)             | Net             |             | % variance |
|------------------------------------|-----------------|-------------|------------|
|                                    | interest income | \$ variance |            |
| Simulated change in interest rates |                 |             |            |
| +200 basis points                  | \$ 21,946       | \$ 1,070    | 5.1 %      |
| +100 basis points                  | 21,225          | 349         | 1.7        |
| Flat rate                          | 20,876          | -           | -          |
| -100 basis points                  | 20,643          | (233)       | (1.1)      |
| -200 basis points                  | 20,162          | (714)       | (3.4)      |

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



## Liquidity

Liquidity management ensures that adequate funds will be available to meet customers' needs for borrowings, deposit withdrawals and maturities, facility expansion and normal operating expenses of the Company. Sources of liquidity are cash and cash equivalents, asset maturities and pay-downs within one year, loans HFS and investments AFS, growth of core deposits and repurchase agreements, utilization of borrowing capacities from the FHLB, correspondent banks, CDARs, the Discount Window of the Federal Reserve Bank of Philadelphia (FRB) and proceeds from the issuance of capital stock. Though regularly scheduled investment and loan payments are dependable sources of daily liquidity, sales of both loans HFS and investments AFS, deposit activity and investment and loan prepayments are significantly influenced by general economic conditions and the interest rate environment. During low and declining interest rate environments, prepayments from interest-sensitive assets tend to accelerate and provide significant liquidity that can be used to invest in other interest-earning assets but at lower market rates. Conversely, in periods of high or rising interest rates, prepayments from interest-sensitive assets tend to decelerate causing cash flow from mortgage loans and mortgage-backed securities to decrease. Rising interest rates may also cause deposit inflow to accelerate but priced at higher market interest rates. The Company closely monitors activity in the capital markets and takes appropriate action to ensure that the liquidity levels are adequate for funding, investing and operating activities.

The Company utilizes a contingency funding plan (CFP) that sets a framework for handling liquidity issues in the event circumstances arise which the Company deems to be less than normal. To accomplish this, the Company established guidelines for identifying, measuring, monitoring and managing the resolution of potentially serious liquidity crises. The Company's CFP outlines required monitoring tools, acceptable alternative funding sources and required actions during various liquidity scenarios. Thus, the Company has implemented a proactive means for the measurement and resolution for handling potentially significant adverse liquidity conditions. At least quarterly, the CFP monitoring tools, current liquidity position and monthly projected

liquidity sources and uses are presented and reviewed by the Company's ALCO. As of June 30, 2013 the Company had not experienced any adverse liquidity issues that would give rise to its inability to raise liquidity in an emergency situation.

During the six months ended June 30, 2013, the Company used approximately \$6.6 million of cash. During the period, the Company's operations provided approximately \$12.3 million mostly from \$7.9 million of net cash inflow from originating and selling residential mortgage loans, \$10.3 million of net cash inflow from the components of net interest income partially offset from net non-interest expense /income related payments. Liquidity generated from operations, deposit inflow, short-term borrowings and cash on hand were used to fund growth in the loan portfolio, dividend payments and equipment acquisition. The \$15.3 million cash on hand as of June 30, 2013 is expected to be used to grow interest-earning assets - mostly to fund growth in the loan portfolio, facility and technology upgrades and deposit outflow.

The Company is a party to financial instruments with off-balance sheet risk in the normal course of business in order to meet the financing needs of its customers and in connection with the overall interest rate management strategy. These instruments involve, to a varying degree, elements of credit, interest rate and liquidity risk. In accordance with GAAP, these instruments are either not recorded in the consolidated financial statements or are recorded in amounts that differ from the notional amounts. Such instruments primarily include lending commitments and lease obligations.

Lending commitments include commitments to originate loans and commitments to fund unused lines of credit. Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since some of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements.

In addition to lending commitments, the Company has contractual obligations related to operating lease commitments. Operating lease commitments are obligations under various non-cancelable operating leases on buildings and land used for office space and banking purposes. The Company's position with respect to lending commitments and significant contractual obligations, both on a short- and long-term basis has not changed materially from December 31, 2012.

As of June 30, 2013, the Company maintained \$15.3 million in cash and cash equivalents and \$101.6 million of investments AFS and loans HFS. Also as of June 30, 2013, the Company had approximately \$137.8 million available to borrow from the FHLB, \$21.0 million from correspondent banks, \$24.5 million from the FRB and \$30.3 million from the CDARS program. The combined total of \$330.5 million represented 54% of total assets at June 30, 2013. Management believes this level of liquidity to be strong and adequate to support current operations.

## Capital

During six months ended June 30, 2013, total shareholders' equity increased \$1.0 million due principally from the \$2.9 million in net income, \$0.7 million from capital contributions from the activities in the Company's dividend reinvestment and employee stock purchase plans (DRP and ESPP, respectively), partially offset by \$1.2 million of dividends declared and by a \$1.5 million of other comprehensive loss from the decline in the fair value of the Company's investment portfolio.

As of June 30, 2013, the Company reported a net unrealized loss position of \$1.3 million, net of tax, from the securities AFS portfolio compared to a net unrealized gain of \$0.2 million as of December 31, 2012. During the past several years, the prolonged sluggish economy has created uncertainty and illiquidity in the financial and capital markets and has created unpredictable volatility on the fair value estimates for securities in banks' investment portfolios. Management believes that most of the volatility in fair value of securities is due to changes in interest

rates, which have begun to slowly rise, and liquidity complications in the financial markets and to a lesser extent to the deterioration in the creditworthiness of the issuers. When U.S. Treasury rates rise, investment securities' pricing will decline and fair values of investment securities will also decline. Bond prices tend to move inversely to the movement of interest rates. During the first half of 2013, the fair value of the Company's pooled trust preferred securities increased \$0.3 million, or 16%, as the unrealized loss declined by \$0.4 million including \$0.1 million in cash payments. The Company did not incur credit related impairment charges for the six months ended June 30, 2013 nor did the Company incur non-credit related impairment losses in the second quarter of 2013. Nonetheless, given the fragile condition of the capital markets, especially in the pooled trust preferred segment, there is no assurance that future realized and unrealized losses will not be recognized from the Company's portfolio of investment securities. To help maintain a healthy capital position, the Company expects to continue to issue stock to participants in the DRP and ESPP plans, a consistent source of capital from the Company's loyal employees and shareholders.

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

Under these guidelines, assets and certain off-balance sheet items are assigned to broad risk categories, each with appropriate weights. The resulting capital ratios represent capital as a percentage of total risk-weighted assets. The appropriate risk-weighting pursuant to regulatory guidelines, requires a gross-up in the risk-weighting of securities that are rated below investment grade, thus significantly inflating the total risk-weighted assets. This requirement had an adverse impact on the total capital and Tier I capital ratios in both 2013 and 2012. The guidelines require all banks and bank holding companies to maintain a minimum ratio of total risk-based capital to total risk-weighted assets (Total Risk Adjusted Capital) of 8%, including Tier I capital to total risk-weighted assets (Tier I Capital) of 4% and Tier I capital to average total assets (Leverage Ratio) of at least 4%. As of June 30, 2013, the Company and the Bank exceeded all capital adequacy requirements to which it was subject.

The Company continues to closely monitor and evaluate alternatives to enhance its capital ratios as the regulatory and economic environments change. The following table depicts the capital amounts and ratios of the Company and the Bank as of June 30, 2013:

| (dollars in thousands)<br>As of June 30, 2013: | Actual    |       | For capital adequacy purposes |        | To be well capitalized under prompt corrective action provisions |         |
|--|-----------|-------|-------------------------------|--------|--|---------|
|  | Amount    | Ratio | Amount                        | Ratio  | Amount   | Ratio   |
| Total capital (to risk-weighted assets)        |           |       |                               |        |  |         |
| Consolidated                                   | \$ 66,978 | 13.7% | ≥ \$ 39,161                   | ≥ 8.0% | N/A  | N/A     |
| Bank   | \$ 66,807 | 13.7% | ≥ \$ 39,157                   | ≥ 8.0% | ≥ \$ 48,947  | ≥ 10.0% |
| Tier I capital (to risk-weighted assets)       |           |       |                               |        |  |         |
| Consolidated                                   | \$ 60,740 | 12.4% | ≥ \$ 19,581                   | ≥ 4.0% | N/A  | N/A     |
| Bank   | \$ 60,660 | 12.4% | ≥ \$ 19,579                   | ≥ 4.0% | ≥ \$ 29,368  | ≥ 6.0%  |
| Tier I capital (to average assets)             |           |       |                               |        |  |         |
| Consolidated                                   | \$ 60,740 | 10.0% | ≥ \$ 24,353                   | ≥ 4.0% | N/A  | N/A     |
| Bank   | \$ 60,660 | 10.0% | ≥ \$ 24,339                   | ≥ 4.0% | ≥ \$ 30,424  | ≥ 5.0%  |

The Company advises readers to refer to the Supervision and Regulation section of Management's Discussion and Analysis of Financial Condition and Results of Operation, of its 2012 Form 10-K for a discussion on the regulatory environment and recent legislation and rulemaking.

#### Regulatory Capital Changes

In July 2013, the federal banking agencies issued final rules to implement the Basel III regulatory capital reforms and changes required by the Dodd-Frank Act. The phase-in period for community banking organizations begins January 1, 2015, while larger institutions (generally those with assets of \$250 billion or more) must begin compliance on January 1, 2014. The final rules call for the following capital requirements:

- A minimum ratio of common tier 1 capital to risk-weighted assets of 4.5%.
- A minimum ratio of tier 1 capital to risk-weighted assets of 6%.
- A minimum leverage ratio of 4%.

In addition, the final rules establishes a common equity tier 1 capital conservation buffer of 2.5% of risk-weighted assets applicable to all banking organizations. If a banking organization fails to hold capital above the minimum capital ratios and the capital conservation buffer, it will be subject to certain restrictions on capital distributions and discretionary bonus payments. The phase-in period for the capital conservation and countercyclical capital buffers for all banking organizations will begin on January 1, 2016.

Under the proposed rules, accumulated other comprehensive income (AOCI) would have been included in a banking organization's common equity tier 1 capital. The final rules allow community banks to make a one-time election not to include these additional components of AOCI in regulatory capital and instead use the existing treatment under the general risk-based capital rules that excludes most AOCI components from regulatory capital. The opt-out election must be made in the first call report or FR Y-9 series report that is filed after the financial institution becomes subject to the final rule.

The final rules permanently grandfather non-qualifying capital instruments (such as trust preferred securities and cumulative perpetual preferred stock) issued before May 19, 2010 for inclusion in the tier 1 capital of banking organizations with total consolidated assets less than \$15 billion as of December 31, 2009 and banking organizations that were mutual holding companies as of May 19, 2010.

The proposed rules would have modified the risk-weight framework applicable to residential mortgage exposures to require banking organizations to divide residential mortgage exposures into two categories in order to determine the applicable risk weight. In response to commenter concerns about the burden of calculating the risk weights and the potential negative effect on credit availability, the final rules do not adopt the proposed risk weights but retain the current risk weights for mortgage exposures under the general risk-based capital rules.

The Company is in the process of assessing the impact of these changes on the regulatory ratios of the Company and the bank on the capital, operations, liquidity and earnings of the Company and the bank.

#### Item 4. Controls and Procedures

As of the end of the period covered by this Quarterly Report on Form 10-Q, an evaluation was carried out by the Company's management, with the participation of its President and Chief Executive Officer and Chief Financial Officer, of the effectiveness of the Company's disclosure controls and procedures, as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934. Based on such evaluation, the President and Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are designed to ensure that information required to be disclosed in the reports the Company files or furnishes under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and regulations, and are effective. The Company made no changes in its internal controls over financial reporting or in other factors that materially affected, or are reasonably likely to materially affect, these controls during the last fiscal quarter ended June 30, 2013.

## PART II - Other Information

#### Item 1. Legal Proceedings

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

#### Item 1A. Risk Factors

Management of the Company does not believe there have been any material changes to the risk factors that were disclosed in the 2012 Form 10-K filed with the Securities and Exchange Commission on March 26, 2013.

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

None

#### Item 3. Default Upon Senior Securities

None

#### Item 4. Mine Safety Disclosures

Not applicable

Item 5. Other Information

None

Item 6. Exhibits

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

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

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

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

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

50

---

Edgar Filing: FIDELITY D & D BANCORP INC - Form 10-Q

- \*10.3 Registrant's 2012 Dividend Reinvestment and Stock Repurchase Plan. Incorporated by reference to Exhibit 4.1 to Registrant's Registration Statement No. 333-183216 on Form S-3 filed with the SEC on August 10, 2012.
  - \*10.4 Registrant's 2000 Independent Directors Stock Option Plan. Incorporated by reference to Exhibit 4.3 to Registrant's Registration Statement No. 333-64356 on Form S-8 filed with the SEC on July 2, 2001.
  - \*10.5 Amendment, dated October 2, 2007, to the Registrant's 2000 Independent Directors Stock Option Plan. Incorporated by reference to Exhibit 10.2 to Registrant's Form 8-K filed with the SEC on October 4, 2007.
  - \*10.6 Registrant's 2000 Stock Incentive Plan. Incorporated by reference to Exhibit 4.4 to Registrant's Registration Statement No. 333-64356 on Form S-8 filed with the SEC on July 2, 2001.
  - \*10.7 Amendment, dated October 2, 2007, to the Registrant's 2000 Stock Incentive Plan. Incorporated by reference to Exhibit 10.1 to Registrant's Form 8-K filed with the SEC on October 4, 2007.
  - \*10.8 Registrant's 2002 Employee Stock Purchase Plan. Incorporated by reference to Appendix A to Definitive proxy Statement filed with the SEC on March 28, 2002.
  - \*10.9 Change of Control Agreement with Salvatore R. DeFrancesco, the Registrant and The Fidelity Deposit and Discount Bank, dated March 21, 2006. Incorporated by reference to Exhibit 99.2 to Registrant's Current Report on Form 8-K filed with the SEC on March 27, 2006.
  - \*10.10 Amended and Restated Executive Employment Agreement between the Registrant, The Fidelity Deposit and Discount Bank and Daniel J. Santaniello, dated March 23, 2011. Incorporated by reference to Exhibit 99.1 to Registrant's Current Report on Form 8-K filed with the SEC on March 29, 2011.
  - \*10.11 Amended and Restated Executive Employment Agreement between the Registrant, The Fidelity Deposit and Discount Bank and Timothy P. O'Brien, dated March 23, 2011. Incorporated by reference to Exhibit 99.2 to Registrant's Current Report on Form 8-K filed with the SEC on March 29, 2011.
  - \*10.12 2012 Omnibus Stock Incentive Plan. Incorporated by reference to Appendix A to Registrant's Definitive Proxy Statement filed with the SEC on March 30, 2012.
  - \*10.13 2012 Director Stock Incentive Plan. Incorporated by reference to Appendix B to Registrant's Definitive Proxy Statement filed with the SEC on March 30, 2012.
  - \*10.14 Change in Control and Severance Agreement between Fidelity D & D Bancorp, Inc., The Fidelity Deposit and Discount Bank and Raymond J. Fox, dated January 14, 2013. Incorporated by reference to Exhibit 99.1 to Registrant's Current Report on Form 8-K filed with the SEC on January 14, 2013.
- 11 Statement regarding computation of earnings per share. Included herein in Note No. 6, "Earnings per share," contained within the Notes to Consolidated Financial Statements, and incorporated herein by reference.
- 31.1 Rule 13a-14(a) Certification of Principal Executive Officer, filed herewith.
- 31.2 Rule 13a-14(a) Certification of Principal Financial Officer, filed herewith.
- 32.1 Certification of Principal Executive Officer pursuant to 18 U.S.C. Section 1350,  
as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, filed herewith.



32.2 Certification of Principal Financial Officer pursuant to 18 U.S.C. Section 1350,

as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, filed herewith.

101 Interactive data files: The following, from Fidelity D&D Bancorp, Inc.'s Quarterly Report on Form 10-Q for the quarter ended June 30, 2013, is formatted in XBRL (eXtensible Business Reporting Language): Consolidated Balance Sheets as of June 30, 2013 and December 31, 2012; Consolidated Statements of Income for the three- and six-months ended June 30, 2013 and 2012; Consolidated Statements of Comprehensive Income for the three- and six-months ended June 30, 2013 and 2012; Consolidated Statements of Changes in Shareholders' Equity for the six months ended June 30, 2013 and 2012, Consolidated Statements of Cash Flows for the six months ended June 30, 2013 and 2012 and the Notes to the Consolidated Financial Statements.

---

\* Management contract or compensatory plan or arrangement.

---

Signatures

FIDELITY D & D BANCORP, INC.

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

Fidelity D & D Bancorp, Inc.

Date: August 13, 2013 /s/Daniel J. Santaniello  
Daniel J. Santaniello,

President and Chief Executive Officer

Fidelity D & D Bancorp, Inc.

Date: August 13, 2013 /s/Salvatore R. DeFrancesco, Jr.  
Salvatore R. DeFrancesco, Jr.,

Treasurer and Chief Financial Officer



EXHIBIT INDEX

|  | Page |
|--|------|
| 3(i) Amended and Restated Articles of Incorporation of Registrant. Incorporated by reference to Annex B of the Proxy Statement/Prospectus included in Registrant's Amendment 4 to its Registration Statement No. 333-90273 on Form S-4, filed with the SEC on April 6, 2000. | *    |
| 3(ii) Amended and Restated Bylaws of Registrant. Incorporated by reference to Exhibit 3(ii) to Registrant's Form 8-K filed with the SEC on November 21, 2007.  | *    |
| 10.1 1998 Independent Directors Stock Option Plan of The Fidelity Deposit and Discount Bank, as assumed by Registrant. Incorporated by reference to Exhibit 10.1 to Registrant's Registration Statement No. 333-90273 on Form S-4, filed with the SEC on November 3, 1999.   | *    |
| 10.2 1998 Stock Incentive Plan of The Fidelity Deposit and Discount Bank, as assumed by Registrant. Incorporated by reference to Exhibit 10.2 of Registrant's Registration Statement No. 333-90273 on Form S-4, filed with the SEC on November 3, 1999.                      | *    |
| 10.3 Registrant's Dividend Reinvestment and Stock Repurchase Plan. Incorporated by reference to Exhibit 4.1 to Registrant's Registration Statement No. 333-183216 on Form S-3 filed with the SEC on August 10, 2012.   | *    |
| 10.4 Registrant's 2000 Independent Directors Stock Option Plan. Incorporated by reference to Exhibit 4.3 to Registrant's Registration Statement No. 333-64356 on Form S-8 filed with the SEC on July 2, 2001.  | *    |
| 10.5 Amendment, dated October 2, 2007, to the Registrant's 2000 Independent Directors Stock Option Plan. Incorporated by reference to Exhibit 10.2 to Registrant's Form 8-K filed with the SEC on October 4, 2007.   | *    |
| 10.6 Registrant's 2000 Stock Incentive Plan. Incorporated by reference to Exhibit 4.4 to Registrant's Registration Statement No. 333-64356 on Form S-8 filed with the SEC on July 2, 2001.   | *    |
| 10.7 Amendment, dated October 2, 2007, to the Registrant's 2000 Stock Incentive Plan. Incorporated by reference to Exhibit 10.1 to Registrant's Form 8-K filed with the SEC on October 4, 2007.  | *    |
| 10.8 Registrant's 2002 Employee Stock Purchase Plan. Incorporated by reference to Appendix A to Registrant's Definitive Proxy Statement filed with the SEC on March 28, 2002.  | *    |

|   |    |
|---|----|
|   | *  |
| 10.9 Change of Control Agreement with Salvatore R. DeFrancesco, the Registrant and The Fidelity Deposit and Discount Bank, dated March 21, 2006. Incorporated by reference to Exhibit 99.2 to Registrant’s Current Report on Form 8-K filed with the SEC on March 27, 2006.                           |    |
|   | *  |
| 10.10 Amended and Restated Executive Employment Agreement between the Registrant, The Fidelity Deposit and Discount Bank and Daniel J. Santaniello, dated March 23, 2011. Incorporated by reference to Exhibit 99.1 to Registrant’s Current Report on Form 8-K filed with the SEC on March 29, 2011.  |    |
|   | *  |
| 10.11 Amended and Restated Executive Employment Agreement between the Registrant, The Fidelity Deposit and Discount Bank and Timothy P. O’Brien, dated March 23, 2011. Incorporated by reference to Exhibit 99.2 to Registrant’s Current Report on Form 8-K filed with the SEC on March 29, 2011.     |    |
|   | *  |
| 10.12 2012 Omnibus Stock Incentive Plan. Incorporated by reference to Appendix A to Registrant’s Definitive Proxy Statement filed with the SEC on March 30, 2012.   |    |
|   | *  |
| 10.13 2012 Director Stock Incentive Plan. Incorporated by reference to Appendix B to Registrant’s Definitive Proxy Statement filed with the SEC on March 30, 2012.  |    |
|   | *  |
| 10.14 Change in Control and Severance Agreement between Fidelity D & D Bancorp, Inc., The Fidelity Deposit and Discount Bank and Raymond J. Fox, dated January 14, 2013. Incorporated by reference to Exhibit 99.1 to Registrant’s Current Report on Form 8-K filed with the SEC on January 14, 2013. |    |
| 11 Statement regarding computation of earnings per share.   | 23 |
| 31.1 Rule 13a-14(a) Certification of Principal Executive Officer.   | 56 |
| 31.2 Rule 13a-14(a) Certification of Principal Financial Officer.   | 57 |
| 32.1 Certification of Principal Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.   | 58 |
| 32.2 Certification of Principal Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.   | 58 |

101 Interactive data files: The following, from the Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2013, is formatted in XBRL (eXtensible Business Reporting Language): Consolidated Balance Sheets as of June 30, 2013 and December 31, 2012; Consolidated Statements of Income for the three- and six- months ended June 30, 2013 and 2012; Consolidated Statements of Comprehensive Income for the three- and six- months ended June 30, 2013 and 2012; Consolidated Statements of Changes in Shareholders' Equity for the six months ended June 30, 2013 and 2012, Consolidated Statements of Cash Flows for the six months ended June 30, 2013 and 2012 and the Notes to the Consolidated Financial Statements. \*\*

---

\* Incorporated by Reference

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

54

---

Exhibit 31.1

CERTIFICATION

I, Daniel J. Santaniello, certify that:

1.I have reviewed this quarterly report on Form 10-Q of Fidelity D & D Bancorp, Inc.;

2.Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3.Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4.The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

(a)Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

(b)Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

(c)Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(d)Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5.The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions);

(a)All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b)Any fraud, whether or not material, that involves management or other employees, who have a significant role in the registrant's internal control over financial reporting.

Date: August 13, 2013

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

Exhibit 31.2

CERTIFICATION

I, Salvatore R. DeFrancesco, Jr., certify that:

1.I have reviewed this quarterly report on Form 10-Q of Fidelity D & D Bancorp, Inc.;

2.Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3.Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4.The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

(a)Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

(b)Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;



(c)Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(d)Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5.The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions);

(a)All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b)Any fraud, whether or not material, that involves management or other employees, who have a significant role in the registrant's internal control over financial reporting.

Date: August 13, 2013 /s/Salvatore R. DeFrancesco, Jr.  
Salvatore R. DeFrancesco, Jr.,  
Treasurer and Chief Financial Officer

Exhibit 32.1

CERTIFICATION PURSUANT TO

18 U.S.C. SECTION 1350

AS ADDED BY

SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report on Form 10-Q of Fidelity D & D Bancorp, Inc. (the "Company") for the period ended June 30, 2013, as filed with the Securities and Exchange Commission (the "Report"), I, Daniel J. Santaniello, President and Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. §1350, as added by

§ 906 of the Sarbanes-Oxley Act of 2002, that:

1.The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

2.To my knowledge, the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company as of and for the period covered by the Report.

Date: August 13, 2013 By: /s/Daniel J. Santaniello  
Daniel J. Santaniello  
President and Chief Executive Officer

Exhibit 32.2

CERTIFICATION PURSUANT TO

18 U.S.C. SECTION 1350

AS ADDED BY

SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report on Form 10-Q of Fidelity D & D Bancorp, Inc. (the "Company") for the period ended June 30, 2013, as filed with the Securities and Exchange Commission (the "Report"), I, Salvatore R. DeFrancesco, Jr., Treasurer and Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. §1350, as added by

§ 906 of the Sarbanes-Oxley Act of 2002, that:

1. The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

2. To my knowledge, the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company as of and for the period covered by the Report.

Date: August 13, 2013 By: /s/Salvatore R. DeFrancesco, Jr.  
Salvatore R. DeFrancesco, Jr.,  
Treasurer and Chief Financial

57

---