# UNITED STATES SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-	·Q
<b>■</b> Quarterly Report pursuant to Section 13 or 15(d) of the	e Securities Exchange Act of 1934
for the Quarterly Period Ended S	eptember 30, 2013
or	
☐ Transition report pursuant to Section 13 or 15(d) of the	
for the Transition Period from	to
Commission File Number No	0. 333-140879
Pennsylvania (State or other jurisdiction of incorporation)	20-8420347 (I.R.S. Employer Identification No.)
2 West Liberty Boulevard, Suite 104 Malvern, Pennsylvania (Address of principal executive offices)	19355 (Zip Code)
Registrant's telephone number, including	area code: (877) 533-4420
Indicate by check mark whether the registrant (1) has filed all reports require Exchange Act during the preceding 12 months (or for such shorter period that sheen subject to such filing requirements for the past 90 days. Yes	nat the Registrant was required to file such reports), and
Indicate by check mark whether the registrant has submitted electronically a Interactive Data File required to be submitted and posted pursuant to Rule 4 for such shorter period that the registrant was required to submit and post submit a	405 of Regulation S-T during the preceding 12 months (or
Indicate by check mark whether the registrant is a large accelerated filer, an reporting company. See the definitions of "large accelerated filer", "accelerated filer", "acceler	

Large accelerated filer  $\square$ 

Non-accelerated filer □

Accelerated filer

Indicate by check mark if the Registrant is a shell company (as defi	ined in Rule 12b-2 of the Exchange Act). Yes □ No ⊠
Indicate the number of shares outstanding of each of the issuer's cl	
Title of Each Class Common Stock, \$1.00 Par Value	Number of Shares Outstanding as of November 5, 2013 6,349,494 Outstanding Shares

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#### CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

This Quarterly Report on Form 10-Q contains forward-looking statements, and as such, statements containing the words "believes," "expects," "anticipates," "estimates," "plans," "projects," "predicts," "intends," "seeks," "will," "may," "should," "would," "continues," "hope" and similar expressions, or the negative of these terms, constitute forward-looking statements that involve risks and uncertainties. Such statements are based on current expectations and are subject to risks, uncertainties and changes in condition, significance, value, and effect. Such risks, uncertainties and changes in condition, significance, value and effect could cause First Priority Financial Corp.'s actual results to differ materially from those anticipated.

Although the Company believes its plans, intentions, and expectations as reflected in or suggested by these forward-looking statements are reasonable, it can give no assurance that its plans, intentions, or expectations will be achieved. Accordingly, you should not place undue reliance on them. Listed below, and discussed elsewhere, are some important risks, uncertainties, and contingencies that could cause actual results, performances, or achievements to be materially different from the forward-looking statements made in this document. These factors, risks, uncertainties, and contingencies include, but are not limited to, the following:

- the strength of the United States economy in general and the strength of the regional and local economies in which First Priority conducts operations;
- the effects of changing economic conditions in First Priority's market areas and nationally;
- the effects of, and changes in, trade, monetary, and fiscal policies and laws, including interest rate policies of the Board of Governors of the Federal Reserve System;
- changes in federal and state banking, insurance, and investment laws and regulations which could impact First Priority's operations;
- inflation, interest rate, market, and monetary fluctuations;
- First Priority's timely development of competitive new products and services in a changing environment and the acceptance of such products and services by customers;
- the impact of changes in financial services policies, laws, and regulations, including laws, regulations, policies, and practices concerning taxes, banking, capital, liquidity, proper accounting treatment, securities, and insurance, and the application thereof by regulatory bodies and the impact of changes in and interpretations of generally accepted accounting principles;
- the occurrence of adverse changes in the securities markets;
- the effects of changes in technology or in consumer spending and savings habits;
- terrorist attacks in the United States or upon United States interests abroad, or armed conflicts involving the United States military;
- regulatory or judicial proceedings;
- changes in asset quality;
- First Priority's ability to effectively integrate the business and operations of Affinity Bancorp, Inc. and/or Affinity Bank of Pennsylvania, which were acquired on February 28, 2013; and
- First Priority's success in managing the risks involved in the foregoing.

The effects of these factors are difficult to predict. New factors emerge from time to time, and we are not able to assess the impact of any such factor on the business or the extent to which any factor, or combination of factors, may cause results to differ materially from those contained in any forward-looking statement. Any forward-looking statements speak only as of the date of this document.

Because these forward-looking statements are subject to assumptions and uncertainties, actual results may differ materially from those expressed or implied by these forward-looking statements. You are cautioned not to place undue reliance on these statements, which speak only as of the date of this quarterly report or the date of any document incorporated by reference in this quarterly report.

First Priority Financial Corp. Consolidated Balance Sheets (Unaudited, in thousands, except share and per share data)

	Sep	otember 30, 2013	De	cember 31, 2012
Assets				
Cash and due from banks	\$	5,638	\$	4,841
Interest-bearing deposits in banks		13,444		6,175
Total cash and cash equivalents		19,082		11,016
Securities available for sale, at fair value (amortized cost: \$56,607 and \$15,996, respectively)		55,691		16,679
Securities held to maturity, at amortized cost (fair value: \$10,428 and \$0, respectively)		11,005		_
Loans receivable		332,197		244,275
Less: allowance for loan losses		2,236		2,460
Net loans		329,961		241,815
Restricted investments in bank stocks		2,461		1,337
Premises and equipment, net		2,553		901
Accrued interest receivable		1,423		1,040
Other real estate owned		907		184
Goodwill		2,725		1,194
Intangible assets with finite lives		520		_
Other assets		1,039		980
Total Assets	\$	427,367	\$	275,146
Liabilities and Shareholders' Equity				
Liabilities				
Deposits:				
Non-interest bearing	\$	38,070	\$	28,176
Interest-bearing		302,765		204,867
Total deposits		340,835		233,043
Short-term borrowings		26,875		_
Long-term debt		11,000		13,000
Accrued interest payable		372		378
Other liabilities		6,057		1,015
Total Liabilities	_	385,139	_	247,436
Shareholders' Equity				
Preferred stock, \$100 par value; authorized 10,000,000 shares; liquidation value: \$1,000 per share:				
Series A: 5%; 4,579 shares issued and outstanding; liquidation value: \$4,579		4,557		4,513
Series B: 9%; 229 shares issued and outstanding; liquidation value: \$229		231		236
Series C: 5%; 4,596 shares issued and outstanding; liquidation value: \$4,596		4,594		4,593
Common stock, \$1 par value; authorized 10,000,000 shares; issued and outstanding: 2013: 6,331,771; 2012: 3,144,053		6,332		3,144
Surplus		39,757		26,230
Accumulated deficit		(12,594)		(11,689)
Accumulated other comprehensive income (loss)		(649)		683
Total Shareholders' Equity		42,228		27,710
Total Liabilities and Shareholders' Equity	\$	427,367	\$	275,146

## First Priority Financial Corp. Consolidated Statements of Operations (Unaudited, in thousands, except per share data)

	Fe	For the three months ended September 30,			For the nine months ended September 30,		
		2013		2012	2013		2012
Interest Income							
Loans receivable, including fees	\$	4,224	\$	3,104	\$ 12,1		\$ 9,299
Securities—taxable		323		167		14	541
Securities—exempt from federal taxes		28		31		34	64
Interest bearing deposits and other		20		2		<u> 17</u>	5
Total Interest Income		4,595	-	3,304	12,90	<u>50</u>	9,909
Interest Expense							
Deposits		745		791	2,20		2,549
Short-term borrowings		9		4		11	6
Long-term debt	_	25		36	12	20	180
Total Interest Expense		779		831	2,39	94	2,735
Net Interest Income		3,816		2,473	10,50	66	7,174
Provision for Loan Losses		230		80	5′	70	410
Net Interest Income after Provision for Loan Losses		3,586		2,393	9,99	96	6,764
Non-Interest Income							
Wealth management fee income		158		71	2'	73	200
Gains on sales of investment securities		_		57	_	-	422
Other		95		39	2:	58	129
Total Non-Interest Income		253		167	5.	31	751
Non-Interest Expenses							
Salaries and employee benefits		1,788		1,326	5,12	29	4,048
Occupancy and equipment		541		269	1,4		785
Data processing equipment and operations		250		140	60	51	385
Professional fees		219		122	5'	73	382
Marketing, advertising, and business development		39		10	14	19	52
FDIC insurance assessments		94		62	2:	59	192
Pennsylvania bank shares tax expense		101		57	2'	77	170
Collateral protection expense		_		_	_	-	168
Merger related costs		324		185	1,5%		328
Other real estate owned		118		_		30	_
Other		278		171	69	96	454
Total Non-Interest Expenses	_	3,752		2,342	11,00	<u>33</u>	6,964
Net Income (Loss)	\$	87	\$	218	\$ (50	06)	\$ 551
Preferred dividends, including net amortization		133		132	39	99	399
Income (loss) to Common Shareholders	\$	(46)	\$	86	\$ (90		\$ 152
Income (loss) per common share:						_	
Basic	\$	(0.01)	\$	0.03	\$ (0.	16)	\$ 0.05
Diluted	\$	(0.01)	\$	0.03	\$ (0.		\$ 0.05
Weighted average common shares outstanding							
Basic		6,332		3,144	5,64	11	3,144
Diluted		6,332		3,152	5,64		3,157
					,		

## First Priority Financial Corp. Consolidated Statements of Comprehensive Income (loss) (Unaudited, in thousands, except per share data)

	For the three s		For the nine mo	
	2013	2012	2013	2012
Net income (loss)	\$ 87	\$ 218	\$ (506)	\$ 551
Other comprehensive income (loss):				
Securities available for sale:				
Net unrealized gains (losses) arising during the period	1	128	(1,599)	(189)
Reclassification adjustment for realized gains included in net income		57		422
Net unrealized gains (losses) on securities available for sale	1	185	(1,599)	233
Net unrealized holding gains (losses) on securities transferred between available for sale and held to maturity:				
Reclassification adjustment for net unrealized holding gains on securities transferred	_	_	293	_
Amortization of net unrealized holding gains (losses) to income during the period	(21)		(26)	
Net unrealized holding gains (losses) on securities transferred during the period	(21)		267	
Total other comprehensive income (loss)	(20)	185	(1,332)	233
Total comprehensive income (loss)	\$ 67	\$ 403	\$ (1,838)	\$ 784

## First Priority Financial Corp. Consolidated Statements of Shareholders' Equity For the Nine Months Ended September 30, 2013 and 2012 (Unaudited, dollars in thousands)

	D C 1	G			Accumulated Other	
	Preferred Stock	Common Stock	Surplus	Accumulated Deficit	Comprehensive Income (loss)	Total
Balance—December 31, 2011	\$ 9,289	\$ 3,142	\$26,062	\$ (11,910)	\$ 861	\$27,444
Preferred stock dividends	_	_	_	(359)	_	(359)
Net amortization on preferred stock	40	_	_	(40)	_	_
Issuance of 1,875 shares of restricted common stock	_	2	(2)	_	_	_
Net income	_	_		551	_	551
Other comprehensive income	_			_	233	233
Stock options expense			136			136
Balance—September 30, 2012	\$ 9,329	\$ 3,144	\$26,196	<u>\$ (11,758)</u>	\$ 1,094	\$28,005
Balance—December 31, 2012	\$ 9,342	\$ 3,144	\$26,230	\$ (11,689)	\$ 683	\$27,710
Preferred stock dividends	_	_	_	(359)	_	(359)
Net amortization on preferred stock	40	_	_	(40)	_	_
Issuance of 3,475 shares of restricted common stock	_	4	(4)	_	_	_
Issuance of 1,268,576 shares of common stock in						
private placement	_	1,268	5,304	_	_	6,572
Issuance of 1,915,942 shares of common stock in						
merger with Affinity Bancorp, Inc.	_	1,916	8,130	_	_	10,046
Cash in lieu of fractional shares for merger with						
Affinity Bancorp, Inc.	_	_	(1)	_	_	(1)
Net loss	_	_	_	(506)	_	(506)
Other comprehensive loss	_	_	_	_	(1,332)	(1,332)
Stock options expense			98			98
Balance—September 30, 2013	\$ 9,382	\$ 6,332	\$39,757	\$ (12,594)	\$ (649)	\$42,228

## First Priority Financial Corp. Consolidated Statements of Cash Flows (Unaudited, dollars in thousands)

	For the nine months ende September 30,			
		2013		2012
Cash Flows from Operating Activities	ф	(506)	Ф	551
Net income (loss)	\$	(506)	\$	551
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		570		410
Provision for loan losses		570		410
Provision for foreclosed asset losses		121		56
Depreciation and amortization		278		190
Net (accretion) amortization of securities premiums		(204)		47
Stock based compensation expense		98		136
Gains on sales of investment securities		_		(422
Gains (losses) on sales of other real estate		6		
Increase (decrease) in accrued interest receivable		14		(67
Increase in other assets		279		36
Decrease in accrued interest payable		(201)		(53
Increase in other liabilities	_	592		433
Net Cash Provided by Operating Activities		1,047	_	1,317
Cash Flows from Investing Activities				
Net increase in loans		(11,089)		(4,288
Purchases of securities available for sale		(33,042)	- (	(11,262)
(Purchase)/Redemption of restricted stock		(26)		(70
Proceeds from maturities or calls of securities available for sale		16,873		7,555
Proceeds from the sale of securities available for sale		1,938		5,096
Proceeds related to receivables for investment securities sold		33,630		_
Proceeds from the sale of other real estate owned		494		_
Net decrease of premises and equipment		(62)		(92
Net cash received from acquisition		24,419		_
Net Cash Provided by (Used in) Investing Activities		33,135	_	(3,061
Cash Flows from Financing Activities				
Net decrease in deposits		(42,846)	- (	(15,551)
Net increase in short-term borrowings		26,875		5,530
Increase (Decrease) in long-term debt		(16,358)		5,000
Proceeds from issuance of common stock		6,572		_
Cash dividends paid on preferred stock		(359)		(359
Net Cash Used in Financing Activities		(26,116)		(5,380
Net Increase (Decrease) in Cash and Cash Equivalents		8,066		(7,124
Cash and Cash Equivalents—Beginning		11,016		16,218
Cash and Cash Equivalents—Ending	\$	19,082	\$	9,094
Supplementary Disclosures of Cash Flows Information				
Noncash activity:				
Trade date accounting for investment securities purchases	\$	4,175	\$	_
Receivable on investment security calls	\$		\$	1,337
Transfer of available for sale securities to held to maturity securities	\$	11,166	\$	_
Cash paid for interest on deposits and borrowings	\$	2,860	\$	2,788
Cash paid for income taxes	\$		\$	47
1				

## First Priority Financial Corp. Unaudited Notes to Consolidated Financial Statements

#### Note 1—Summary of Significant Accounting Policies

#### **Organization and Nature of Operations**

First Priority Financial Corp.

First Priority Financial Corp. ("First Priority", the "Company") was incorporated under the laws of the Commonwealth of Pennsylvania on February 13, 2007, for the purpose of becoming the holding company of First Priority Bank (the "Bank") and had no prior operating history. On May 11, 2007, as a result of a reorganization and merger where each outstanding share of First Priority Bank common stock and each outstanding warrant to acquire a share of First Priority Bank common stock were converted into one share of First Priority common stock and one warrant to acquire First Priority common stock, First Priority Bank became a whollyowned subsidiary of First Priority.

On February 29, 2008, First Priority acquired Prestige Community Bank ("Prestige") and Prestige merged with and into First Priority Bank.

On May 23, 2012, First Priority and Affinity Bancorp, Inc. ("Affinity"), the holding company for Affinity Bank of PA ("Affinity Bank"), jointly announced a definitive agreement to merge their respective holding companies and bank subsidiaries. Subsequently, on February 28, 2013, the merger with Affinity was completed. Total assets acquired as a result of the merger were \$175.9 million, including \$77.4 million in loans, and deposits of \$150.9 million. Affinity operated five branch offices within the Berks County, Pennsylvania market. Under the terms of the merger agreement, shareholders of Affinity received 0.9813 newly issued shares of First Priority in exchange for each Affinity share. A total of 1,915,942 shares of First Priority common stock were issued in connection with the merger. Also, in conjunction with the completion of the merger, the Company also issued 1,268,576 shares of First Priority common stock as part of a private placement offering resulting in incremental net equity proceeds of \$6.6 million.

First Priority provides banking services through First Priority Bank and does not engage in any activities other than banking and related activities. As of September 30, 2013, First Priority had total assets of \$427.4 million and total shareholders' equity of \$42.2 million.

#### First Priority Bank

First Priority Bank is a state-chartered commercial banking institution which was incorporated under the laws of the Commonwealth of Pennsylvania on May 25, 2005. First Priority Bank's deposits are insured by the FDIC up to the maximum amount permitted for all banks. As of September 30, 2013, First Priority Bank had total assets of \$427.3 million, total loans of \$332.2 million, total deposits of \$341.9 million and total shareholder's equity of \$41.5 million.

First Priority Bank engages in a full service commercial and consumer banking business with strong private banking and individual wealth management services. First Priority Bank offers a variety of consumer, private banking and commercial loans, mortgage products and commercial real estate financing. First Priority Bank does not engage in sub-prime lending. The Company's operations are significantly affected by prevailing economic conditions, competition, and the monetary, fiscal, and regulatory policies of governmental agencies. Lending activities are influenced by a number of factors, including the general credit needs of individuals and small and medium-sized businesses in the Company's market area, competition, the current regulatory environment, the level of interest rates, and the availability of funds. Deposit flows and costs of funds are influenced by prevailing market rates of interest, competition, account maturities, and the level of personal income and savings in the market area.

First Priority Bank also offers certain financial planning and investment management services. These investment services are provided by First Priority Financial Services, a Division of First Priority Bank, through an agreement with a third party provider. In addition, various life insurance products are offered through First Priority Bank, and the Bank has also entered into solicitation agreements with several investment advisors to provide portfolio management services for introduced customers of the Bank.

The ability to originate loans and build a sound, growing loan portfolio is critically important to the success of First Priority Bank. The Bank provides highly customized loan products offered with excellent service and expertise with a goal of timely responsiveness within the market, and delivers these products and quality services through a staff of highly experienced lenders who are properly supported in the marketplace by seasoned management. The Bank's lenders provide true relationship banking based upon a deep understanding of client needs, personal service, prompt decision making and customized banking solutions.

First Priority Bank currently seeks deposits and commercial and private banking relationships through its ten banking offices. The Bank provides deposit products that include checking, money market and savings accounts, and certificates of deposit as well as other deposit services, including cash management and electronic banking products and online account opening capabilities. The Bank obtains funding in the local community by providing excellent service and competitive rates to its customers and utilizes electronic and print media advertising to attract current and potential deposit customers. The Bank also uses brokered certificates of deposit as a cost effective funding alternative.

#### **Basis of Presentation**

The accompanying unaudited consolidated financial statements were prepared in accordance with instructions to Form 10-Q, and therefore, do not include information or all footnotes necessary for a complete presentation of financial position, results of operations and cash flows in conformity with accounting principles generally accepted in the United States ("GAAP"). However, all normal recurring adjustments that, in the opinion of management, are necessary for a fair presentation of these financial statements have been included. These financial statements should be read in conjunction with the audited consolidated financial statements and the notes thereto for First Priority Financial Corp. for the year ended December 31, 2012, included in the Company's Form 10-K filed with the Securities and Exchange Commission on April 9, 2013. The results of interim periods presented are not necessarily indicative of the results that may be expected for the year ending December 31, 2013.

The accompanying unaudited consolidated financial statements consist of the parent company, First Priority Financial Corp. and its consolidated wholly owned subsidiary, First Priority Bank. The consolidated balance sheets and related statements of income of the Company are substantially the same as the consolidated balance sheets and related statements of income of the Bank. All significant intercompany accounts and transactions have been eliminated in consolidation.

#### **Acquired Loans**

Acquired loans are initially recorded at their acquisition date fair values. The carryover of allowance for loan losses is prohibited as any credit losses in the loans are included in the determination of the fair value of the loans at the acquisition date. Fair values for acquired loans are based on a discounted cash flow methodology that involves assumptions and judgments as to credit risk, prepayment risk, liquidity risk, default rates, loss severity, payment speeds, collateral values and discount rate.

For acquired loans that are not deemed impaired at acquisition, credit discounts representing principal losses expected over the life of the loan are a component of the initial fair value. Subsequent to the acquisition date, the methods used to estimate the required allowance for loan losses for these loans is similar to originated loans. However, the Company records a provision for loan losses only when the required allowance exceeds any remaining credit discount. The remaining differences between the acquisition date fair value and the unpaid principal balance at the date of acquisition are recorded in interest income over the life of the loan.

Acquired loans that have evidence of deterioration in credit quality since origination and for which it is probable, at acquisition, that the Company will be unable to collect all contractually required payments are accounted for as impaired loans under ASC 310-30. The excess of cash flows expected at acquisition over the estimated fair value is referred to as the accretable discount and is recognized into interest income over the remaining life of the loans. The difference between contractually required payments at acquisition and the cash flows expected to be collected at acquisition is referred to as the non-accretable discount. The non-accretable discount represents estimated future credit losses expected to be incurred over the life of the loan. Subsequent decreases to the expected cash flows require the Company to evaluate the need for an allowance for loan losses on these loans. Subsequent improvements in expected cash flows result in the reversal of a corresponding amount of the non-accretable discount which the Company then reclassifies as an accretable discount that is recognized into interest income over the remaining life of the loans using the interest method.

Acquired loans that met the criteria for non-accrual of interest prior to acquisition may be considered performing upon acquisition, or in the future, regardless of whether the customer is contractually delinquent, if the Company can reasonably estimate the timing and amount of the expected cash flows on such loans and if the Company expects to fully collect the new carrying value of the loans. As such, the Company may no longer consider the loan to be non-accrual or non-performing and may accrue interest on these loans, including the impact of any accretable discount. For acquired loans that are not deemed impaired at acquisition, credit discounts representing the principal losses expected over the life of the loan are a component of the initial fair value and amortized over the life of the asset. Subsequent to the acquisition date, the methods utilized to estimate the required allowance for loan losses for these loans is similar to originated loans, however, the Company records a provision for loan losses only when the required allowance exceeds any remaining pooled discounts for loans evaluated collectively for impairment.

#### **Allowance for Loan Losses**

The allowance for credit losses consists of the allowance for loan losses and the reserve for unfunded lending commitments. The allowance for loan losses represents management's estimate of losses inherent in the loan portfolio as of the balance sheet date and is recorded as a reduction to loans. The reserve for unfunded lending commitments represents management's estimate of losses inherent in its unfunded loan commitments and is recorded in other liabilities on the consolidated balance sheet. The allowance for loan losses is increased by the provision for loan losses, and decreased by charge-offs, net of recoveries. Loans deemed to be uncollectible are charged against the allowance for loan losses, and subsequent recoveries, if any, are credited to the allowance. All, or part, of the principal balance of loans receivable are charged off to the allowance as soon as it is determined that the repayment of all, or part, of the principal balance is highly unlikely. Because all identified losses are immediately charged off, no portion of the allowance for loan losses is restricted to any individual loan or groups of loans, and the entire allowance is available to absorb any and all loan

losses.

The allowance for loan losses is maintained at a level considered adequate to provide for losses that can be reasonably anticipated. Management performs a quarterly evaluation of the adequacy of the allowance. The allowance is based on the Company's past loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay, the estimated value of any underlying collateral, composition of the loan portfolio, current economic conditions and other relevant factors. This evaluation is inherently subjective as it requires material estimates that may be susceptible to significant revision as more information becomes available.

The allowance consists of specific, general and unallocated components. The specific component relates to loans that are classified as impaired. For loans that are classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value of that loan. The general component covers pools of loans by loan class including commercial loans not considered impaired, as well as smaller balance homogeneous loans, such as residential real estate, home equity and other consumer loans. These pools of loans are evaluated for loss exposure based upon historical loss rates for each of these categories of loans, adjusted for qualitative factors. These qualitative risk factors include:

- 1. Lending policies and procedures, including underwriting standards and collection, charge-off, and recovery practices.
- 2. National, regional, and local economic and business conditions as well as the condition of various market segments, including the value of underlying collateral for collateral dependent loans.
- 3. Nature and volume of the portfolio and terms of loans.
- 4. Management team with experience, depth, and knowledge in banking and in many areas of lending. Each contributes to the sound credit culture and control within the Bank.
- 5. Volume and severity of past due, classified and nonaccrual loans as well as and other loan modifications.
- 6. The Bank engages a third party to perform an independent review of the loan portfolio as a measure for quality and consistency in credit evaluation and credit decisions.
- 7. Existence and effect of any concentrations of credit and changes in the level of such concentrations.
- 8. Effect of external factors, such as competition and legal and regulatory requirements.

Each factor is assigned a value to reflect improving, stable or declining conditions based on management's best judgment using relevant information available at the time of the evaluation. Adjustments to the factors are supported through documentation of changes in conditions in a narrative accompanying the allowance for loan loss calculation.

A majority of the Bank's loans are to business owners of many types. The Bank makes commercial loans for real estate development and other business purposes required by our customers.

The Bank's credit policies determine advance rates against the different forms of collateral that can be pledged against commercial loans. Typically, the majority of loans will be limited to a percentage of their underlying collateral values such as real estate values, equipment, eligible accounts receivable and inventory. Individual loan advance rates may be higher or lower depending upon the financial strength of the borrower and/or term of the loan. The assets financed through commercial loans are used within the business for its ongoing operation. Repayment of these kinds of loans generally comes from the cash flow of the business or the ongoing conversions of assets. Commercial real estate loans include long-term loans financing commercial properties. Repayment of this kind of loan is dependent upon either the ongoing cash flow of the borrowing entity or the resale of or lease of the subject property. Commercial real estate loans typically require a loan to value ratio of not greater than 80% and vary in terms.

Residential mortgages and home equity loans are secured by the borrower's residential real estate in either a first or second lien position. Residential mortgages and home equity loans have varying loan rates depending on the financial condition of the borrower and the loan to value ratio. Residential mortgages have amortizations up to 30 years and home equity loans have maturities up to 10 years.

Other consumer loans include installment loans, car loans, and overdraft lines of credit. The majority of these loans are secured.

An unallocated component of the allowance for loan losses is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

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 of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case- by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan by loan basis for commercial and industrial loans, commercial real estate loans and commercial construction loans by either the present value of expected future cash flows discounted at the loan's effective interest rate or the fair value of the collateral if the loan is collateral dependent.

An allowance for loan losses is established for an impaired loan if its carrying value exceeds its estimated fair value. The estimated fair values of substantially all of the Company's impaired loans are measured based on the estimated fair value of the loan's collateral.

For commercial loans secured by real estate, estimated fair values are determined primarily through third-party appraisals. When a real estate secured loan becomes impaired, a decision is made regarding whether an updated certified appraisal of the real estate is necessary. This decision is based on various considerations, including the age of the most recent appraisal, the loan-to-value ratio based on the original appraisal and the condition of the property. Appraised values may be discounted to arrive at the estimated selling price of the collateral, which is considered to be the estimated fair value. The discounts also include estimated costs to sell the property.

For commercial and industrial loans secured by non-real estate collateral, such as accounts receivable, inventory and equipment, estimated fair values are determined based on the borrower's financial statements, inventory reports, accounts receivable aging or equipment appraisals or invoices. Indications of value from these sources are generally discounted based on the age of the financial information or the quality of the assets.

Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Company does not separately identify individual residential mortgage loans, home equity loans and other consumer loans for impairment disclosures, unless such loans are the subject of a troubled debt restructuring agreement.

Acquired loans are recorded at acquisition date at their acquisition date fair values, and therefore, are excluded from the calculation of loan loss reserves as of the acquisition date. To the extent there is a decrease in the present value of cash flows expected from the acquired impaired loans after the date of acquisition, the Company records a provision for potential losses. During the three and nine months ended September 30, 2013, the Company recorded a provision for loan losses totaling \$89 thousand for acquired impaired loans. There were no acquired loans as of September 30, 2012.

For acquired loans that are not deemed impaired at acquisition, credit discounts representing the principal losses expected over the life of the loan are a component of the initial fair value. Subsequent to the acquisition date, the methods utilized to estimate the required allowance for loan losses for these loans is similar to originated loans, however, the Company records a provision for loan losses only when the required allowance exceeds any remaining pooled discounts for loans evaluated collectively for impairment. During the nine months ended September 30, 2013, the Company recorded a provision for loan losses totaling \$118 thousand on acquired non-impaired loans. There were no acquired loans as of September 30, 2012.

The allowance calculation methodology includes further segregation of loan classes into risk rating categories. The borrower's overall financial condition, repayment sources, guarantors and value of collateral, if appropriate, are evaluated annually for commercial loans or when credit deficiencies arise, such as delinquent loan payments, for commercial and consumer loans. Credit quality risk ratings include regulatory classifications of special mention, substandard, doubtful and loss. Loans criticized special mention have potential weaknesses that deserve management's close attention. If uncorrected, the potential weaknesses may result in deterioration of the repayment prospects. Loans classified substandard have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They include loans that are inadequately protected by the current sound net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans classified doubtful have all the weaknesses inherent in loans classified substandard with the added characteristic that collection or liquidation in full, on the basis of current conditions and facts, is highly improbable. Loans classified as a loss are considered uncollectible and are charged to the allowance for loan losses. Loans not classified are rated pass.

In addition, Federal regulatory agencies, as an integral part of their examination process, periodically review the Company's allowance for loan losses and may require the Company to recognize additions to the allowance based on their judgments about information available to them at the time of their examination, which may not be currently available to management. Based on management's comprehensive analysis of the loan portfolio, management believes the current level of the allowance for loan losses is adequate.

#### **Subsequent Events**

The Company has evaluated subsequent events for potential recognition and/or disclosure through the date that these financial statements were issued.

#### **Estimates**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, stock-based compensation, impairment of goodwill, impairment of investments and restricted investments in bank stocks and the valuation of deferred tax assets and other real estate owned.

#### **Restricted Investments in Bank Stocks**

Restricted investments in bank stocks, which represents the required investment in the common stock of correspondent banks, are carried at cost and consist of stock of the Federal Home Loan Bank of Pittsburgh ("FHLB") and Atlantic Central Bankers Bank. Federal law requires a member institution of the FHLB to hold FHLB stock according to a predetermined formula. Management's determination of whether these investments are impaired is based on management's assessment of the ultimate recoverability of their cost rather than by recognizing temporary declines in value.

#### Note 2—Merger with Affinity Bancorp, Inc.

On February 28, 2013, First Priority and Affinity Bancorp, Inc. completed a merger, pursuant to a definitive merger agreement dated May 23, 2012, whereby the companies agreed to merge their respective holding companies and bank subsidiaries. Under the terms of the merger agreement, shareholders of Affinity received 0.9813 newly issued shares of First Priority in exchange for each Affinity share. A total of 1,915,942 shares of First Priority common stock were issued in connection with the merger. The combination created a full-service community bank with ten offices serving the Berks, Chester, Montgomery and Bucks County markets. The Company is headquartered in Malvern, PA.

The acquisition is being accounted for using acquisition accounting, which requires the Company to allocate the total consideration transferred to the assets acquired and liabilities assumed, based on their respective fair values at the merger date, with any remaining excess consideration being recorded as goodwill. The fair value of total assets acquired as a result of the merger totaled \$175.9 million, which consisted of \$77.4 million in loans, \$33.3 million in securities available for sale, \$24.4 million in cash and due from banks and \$38.7 million in other assets, of which \$33.6 million was related to receivables for investment securities sold prior to the merger, pending settlement. The transaction also resulted in a core deposit intangible asset of \$582 thousand and goodwill of \$1.5 million. The fair value of liabilities assumed aggregated \$165.8 million, including \$150.9 million of deposits and \$14.4 million in long-term borrowings, of which the borrowings were subsequently paid off in the first quarter of 2013. The transaction added \$10.0 million to First Priority's equity based on the fair value of stock issued in the acquisition. The results of Affinity's operations have been included in the Company's consolidated financial statements prospectively from the date of the merger.

The fair value estimates are subject to change for up to one year after the closing date of the transaction if additional information relative to the closing date fair values becomes available. As the Company continues to analyze the acquired assets and liabilities, there may be adjustments to the recorded carrying values.

(In thousands, except share and per share data)	Februar	y 28, 2013
Purchase Price Consideration in Common Stock		
Affinity common shares settled for stock	1,952,644	
Exchange ratio	0.9813	
First Priority shares issued	1,915,942	
Fair value assigned to First Priority's common shares	\$ 5.22	
Acquisition cost of Affinity common shares exchanged for First Priority		
Stock—Total Acquisition cost		\$ 10,001
Acquisition cost of Consideration—Affinity Options Rolled over to First		
Priority Options		44
Total Acquisition cost		10,045
Identifiable assets:		
Cash and due from banks	\$ 24,419	
Securities available for sale	33,253	
Loans and leases	77,359	
Intangible assets	582	
Other assets	38,738	
Total identifiable assets		174,351
Liabilities:		
Deposits	\$ 150,904	
Long-term borrowings	14,358	
Other liabilities	575	
Total liabilities		165,837
Net goodwill resulting from merger		\$ 1,531

The acquired assets and assumed liabilities were measured at estimated fair values. In many cases, determining the fair value of the acquired assets and assumed liabilities required First Priority to estimate cash flows expected to result from those assets and liabilities and to discount those cash flows at appropriate rates of interest, which required the utilization of significant estimates and judgment in accounting for the acquisition. As of February 28, 2013, goodwill totaled \$1.0 million based on acquisition accounting and the fair values assigned to respective balance sheet categories at the merger date. Subsequently, adjustments related to the fair value of acquired loans were recorded totaling \$525 thousand which increase the resulting goodwill from the merger to \$1.5 million.

The estimated fair values of cash and due from banks, other assets and other liabilities approximate their stated value.

The estimated fair values of the investment securities available for sale were calculated primarily using level 2 inputs. The prices for these instruments are obtained through an independent pricing service and are derived from market quotations and matrix pricing. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the bond's terms and conditions, among other things. Management reviewed the data and assumptions used in pricing the securities to ensure the highest level of significant inputs are derived from market observable data.

Real estate acquired through foreclosure, included in other assets, was primarily valued based on estimated or appraised collateral values.

The most significant fair value determination related to the valuation of acquired loans. Management measured loan fair values based on loan file reviews (including borrower financial statements or tax returns), appraised collateral values, expected cash flows and historical loss factors. The business combination resulted in the acquisition of loans with and without evidence of credit quality deterioration.

Affinity's loans without evidence of credit deterioration were fair valued by discounting both expected principal and interest cash flows using an observable discount rate for similar instruments that a market participant would consider in determining fair value. Additionally, consideration was given to management's best estimates of default rates and payment speeds. At acquisition, Affinity's loan portfolio without evidence of deterioration was recorded at a current fair value of \$74.6 million. The Company utilized an interest rate loan fair value analysis, which resulted in a positive fair value adjustment of \$1.6 million related to this portion of the acquired loans and a general credit fair value analysis which resulted in an offsetting \$1.6 million reduction in the fair value.

To prepare the interest rate loan fair value analysis loans were assembled into groupings by characteristics such as loan type, term, collateral and rate. Market rates for similar loans were obtained from various external data sources and reviewed by Company management for reasonableness. The average of these rates was used as the fair value interest rate a market participant would utilize.

A present value approach was utilized to calculate the interest rate fair value adjustment. The general credit risk fair value adjustment was calculated using a two part general credit fair value analysis: (1) expected lifetime losses, using an average of historical losses of the Company, Affinity and peer banks; and (2) an estimated fair value adjustment for qualitative factors related to general economic conditions and the risk related to lack of familiarity with the originator's underwriting process.

Affinity's loans were deemed impaired at the acquisition date if the Company did not expect to receive all contractually required cash flows due to concerns about credit quality. Such loans were fair valued and the difference between contractually required payments at the acquisition date and cash flows expected to be collected was recorded as a nonaccretable difference. Effectively at the acquisition date, the Company recorded \$2.8 million of purchased credit-impaired loans subject to a nonaccretable discount difference of \$1.6 million. The method of measuring carrying value of purchased loans differs from loans originated by the Company ("originated loans"), and as such, the Company identifies purchased loans and purchased loans with a credit quality discount and originated loans at amortized cost. The aggregate expected cash flows less the acquisition date fair value will result in an accretable yield amount of \$292 thousand, which will be recognized over the life of the loans on a level yield basis as an adjustment to yield.

The following is a summary of the acquired impaired loans resulting from the merger with Affinity (dollars in thousands):

	Acquired Impaired Lo		
Contractually required principal and interest at acquisition	\$	5,577	
Contractual cash flows not expected to be collected		2,441	
Expected cash flows at acquisition		3,136	
Interest component of expected cash flows		359	
Basis in acquired loans at acquisition—estimated fair value	\$	2,777	

The fair value of demand deposits, money market and savings deposits acquired through the merger with Affinity was assumed to be approximately the carrying value as these accounts have no stated maturity and are payable on demand. Certificate of deposit accounts were valued as the present value of the certificates expected contractual payments discounted at market rates for similar certificates.

Core deposit intangibles (CDI) represent the value assigned to demand, interest checking, money market and savings accounts acquired as part of an acquisition. The CDI value represents the future economic benefit of the potential cost savings from acquiring Core Deposits as part of an acquisition compared to the cost of alternative funding sources and the alternative cost to grow a similar core deposit base. The core deposit intangible of \$582 thousand is being amortized over an estimated useful life of approximately 10 years.

The following table shows amortization expense for the core deposit intangible for the next 5 years:

In thousands	
Nine months Ended September 30, 2013	\$ 62
Nine months Ended September 30, 2012	<u>—</u>
Remainder of 2013:	26
2014	97
2015	86
2016	76
2017	65
2018	55

Management used specific market quotations from the FHLB to fair value long-term FHLB advances. These borrowings were subsequently paid off by the Company in the first quarter of 2013 at the recorded fair values.

In addition, the Company has determined, based on the analysis of available positive and negative evidence, that a valuation allowance should be recorded against deferred taxes of the Company. Therefore, the incremental net deferred tax assets resulting from the merger with Affinity, totaling \$1.8 million, were fully reserved by a valuation allowance. Affinity had a Federal net operating loss carryforward ("NOL") for tax purposes of \$1.5 million, or a \$500 thousand tax impact at the statutory federal income tax rate of 34%, which is subject to certain limitations and expires in 2028 if not fully utilized. The \$500 thousand deferred tax asset related to the NOL is included in the \$1.8 million net deferred tax asset discussed above.

In connection with the Affinity acquisition, First Priority incurred merger-related expenses in regards to personnel, professional fees, occupancy and equipment and other costs of integrating and conforming acquired operations with and into First Priority. Those expenses consisted largely of costs related to professional and consulting services, consolidating a branch office, termination of Affinity's core system contractual agreement and conversion of systems and/or integration of operations, initial communication expenses to introduce First Priority to its new customers, printing and filing costs of completing the transaction and investment banking charges.

A summary of merger related costs included in the consolidated statements of income follows (dollars in thousands):

	Ended Sep	Three Months Ended September 30, 2013 2012		ember 30,
A construction	<u>2013</u>		2013	2012
Accounting	\$ —	\$ 62	\$ 26	\$ 67
Branch consolidation			103	
Investment banking	_	_	350	
Investor & customer document printing and filing	35	14	153	14
Legal	_	109	5	247
Purchase accounting consulting	_		50	_
Salaries and employee benefits	83	_	83	_
System contract termination	_		314	_
System conversion/deconversion costs	206		450	
	\$ 324	\$ 185	\$ 1,534	\$ 328

#### **Pro Forma Condensed Combined Financial Information**

The following table presents unaudited pro forma information as if the merger between First Priority and Affinity had been completed on January 1, 2012. These amounts do not include merger related expenses. Supplemental pro forma earnings for 2013 were adjusted to exclude \$324 thousand and \$1.78 million of merger related costs incurred in the three and nine month periods ended September 30, 2013, respectively; the results for the first nine months of 2012 were adjusted to include these charges. The pro forma information does not necessarily reflect the results of operations that would have occurred had the Company merged with Affinity at the beginning of 2012. Cost savings are also not reflected in the unaudited pro forma amounts for the periods presented, respectively. The pro forma financial information does not include the impact of possible business model changes, nor does it consider any potential impacts of current market conditions or revenues, expense efficiencies, or other factors.

	ended Sep	ree months tember 30,	ended Sep	ine months otember 30,
	2013	(Dollars in 2012	n thousands) 2013	2012
Total revenue, consisting of net interest income plus non-interest income	\$ 4,220	\$ 3,992	\$13,054	\$12,302
Net income (loss)	\$ 527	\$ 418	\$ 1,870	\$ (619)

#### **Note 3—Recently Issued Accounting Standards**

In February 2013, the Financial Accounting Standards Board, or FASB issued Accounting Standards Update (ASU) 2013-02, "Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income". ASU 2013-02 requires reporting the effect of significant reclassifications out of accumulated other comprehensive income by component on the respective line items in the income statement parenthetically or in the notes to the financial statements if the amounts being reclassified are required under U.S. GAAP to be reclassified in their entirety to net income. This ASU is effective for public companies prospectively for fiscal years, and interim periods within those years, beginning after December 15, 2012 and early adoption is permitted. The adoption of ASU 2013-02 did not have an impact on our results of operations or financial position.

In January 2013, the FASB issued ASU 2013-01, "Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities" in order to clarify the scope of ASU 2011-11, "Disclosures About Offsetting Assets and Liabilities", issued in December 2011. ASU 2011-11 required entities to disclose both gross and net information about instruments and transactions eligible for offset in the statement of financial position and instruments and transactions subject to an agreement similar to a master netting arrangement. This ASU was issued to allow investors to better compare financial statements prepared under U.S. GAAP with financial statements prepared under International Financial Reporting Standards, or IFRS. ASU 2013-01 clarified that ASU 2011-11 applies to derivatives, sale and repurchase agreements and reverse sale of repurchase agreements, and securities borrowing and securities lending arrangements, but does not apply to standard commercial contracts allowing either party to net in the event of default or to broker-dealer unsettled regular-way trades. Both ASUs are effective for public companies retrospectively for fiscal years, and interim periods within those years, beginning on or after January 1, 2013. The adoption of ASU 2013-02 and ASU 2011-11 did not have an impact on our results of operations or financial position.

In February 2013, the FASB issued ASU 2013-04 "Obligations Resulting from Joint and Several Liability Arrangements for Which the Total Amount of the Obligation is fixed at the Reporting Date". The ASU requires the measurement of obligations resulting from joint and several liability arrangements for which the total amount of the obligation is fixed at the reporting date as the sum of the amount the reporting entity agreed to pay on the basis of its arrangement with its co-obligors as well as any additional amount that the entity expects to pay on behalf of its co-obligors. The new standard is effective retrospectively for fiscal years and interim periods within those years, beginning after December 15, 2013, and early adoption is permitted. We are currently evaluating the implications of ASU 2013-04.

#### Note 4—Earnings (Loss) Per Common Share

Diluted earnings (loss) per common share take into account the potential dilution that could occur if securities or other contracts to issue common stock were exercised and converted into common stock. Proceeds assumed to have been received on such exercise or conversion, are assumed to be used to purchase shares of the Company's common stock at the average market price during the period, as required by the "treasury stock method" of accounting for common stock equivalents. For purposes of calculating the basic and diluted earnings (loss) per share, the Company's reported net income (loss) is adjusted for dividends on preferred stock and net accretion/amortization related to the issuance of preferred stock to determine the net income (loss) to common shareholders. For the three and nine months ended September 30, 2013 diluted loss per share is the same as basic loss per share, as the effect of any common stock equivalent is antidilutive.

The calculations of basic and diluted earnings (loss) per common share are presented below for the three and nine months ended September 30, 2013 and 2012:

		Three Mon Septem				Nine Mon Septem		
	(1	n thousand share info			(]	In thousand share info		
		2013		2012		2013		2012
Net income (loss)	\$	87	\$	218	\$	(506)	\$	551
Less: preferred stock dividends		(119)		(119)		(359)		(359)
Less: net discount accretion on preferred stock		(14)		(13)		(40)		(40)
Income (loss) to common shareholders	\$	(46)	\$	86	\$	(905)	\$	152
Average basic common shares outstanding		6,332		3,144		5,641		3,144
Effect of dilutive stock options			_	8			_	13
Average number of common shares used to calculate diluted								
earnings per common share		6,332		3,152		5,641		3,157
Basic earnings (loss) per common share	\$	(0.01)	\$	0.03	\$	(0.16)	\$	0.05
Diluted earnings (loss) per common share	\$	(0.01)	\$	0.03	\$	(0.16)	\$	0.05

The amount of preferred stock dividends and the net accretion or amortization related to each series of preferred stock is presented below for the three and nine months ended September 30, 2013 and 2012:

	]	For the three Septen	months end nber 30,		e months en ember 30,	nded	
		2013	2	012	2013		2012
		(Dollars in	thousands)		 (Dollars	in thousand	ls)
Preferred dividends:							
Preferred Series A	\$	57	\$	57	\$ 172	\$	172
Preferred Series B		5		5	15		15
Preferred Series C		57		57	 172		172
Total preferred dividends	\$	119	\$	119	\$ 359	\$	359
Net accretion (amortization) on preferred stock:							
Preferred Series A	\$	(14)	\$	(14)	\$ (43)	\$	(43)
Preferred Series B		2		2	5		5
Preferred Series C		(2)		(1)	 (2)		(2)
Total net accretion (amortization) on preferred stock	\$	(14)	\$	(13)	\$ (40)	\$	(40)

#### Note 5—Securities

Management determines the appropriate classification of debt securities at the time of purchase and re-evaluates such designation as of each balance sheet date. Securities classified as available for sale are those securities that the Company intends to hold for an indefinite period of time, but not necessarily to maturity. Available for sale securities are carried at fair value.

Unrealized gains and losses on available for sale investment securities are reported as increases or decreases in other comprehensive income as a component of shareholders' equity. Realized gains or losses, determined on the basis of the cost of the specific securities sold, are included in earnings. Premiums and discounts are recognized in interest income using the interest method over the term of each security. Any decision to sell a security classified as available for sale would be based on various factors, including significant movements, or anticipated movements in interest rates, changes in the maturity mix of the Company's assets and liabilities, liquidity needs, regulatory capital considerations and other similar factors.

Securities classified as held to maturity are those debt securities the Company has both the intent and ability to hold to maturity regardless of changes in market conditions, liquidity needs or changes in general economic conditions. These securities are carried at cost adjusted for the amortization of premium and accretion of discount, computed by a method which approximates the interest method over the terms of the securities. There were no securities classified as held to maturity as of December 31, 2012. During the second quarter of 2013, the Company transferred securities with fair values of \$11.2 million of obligations of states and political subdivisions from available for sale securities to held to maturity securities.

Net unrealized holding gains arising prior to the reclassification date as of May 31, 2013 totaling \$293 thousand are reported as a separate line item within accumulated other comprehensive income when reclassified from available for sale investments to held to maturity investments. This balance, totaling \$267 thousand as of September 30, 2013, is being amortized over the remaining life of the related securities as an adjustment of yield in a manner consistent with the accretion of discount on the same transferred debt securities. This will have no impact on the Company's net income because the amortization of the unrealized holding loss reported in equity will offset the effect on the interest income of the accretion of the discount on these securities. The transfer of securities from available for sale to held to maturity was completed in order to mitigate the volatility to common equity caused by sudden market fluctuations and to lock in a predictable earnings on these related securities.

The amortized cost, unrealized gains and losses, and the estimated fair value of the Company's investment securities available for sale and held to maturity are as follows:

	As of September 30, 2013 Gross Gross											
	A	mortized Cost	Un	Gross realized Gains (Dollars in	U	nrealized Losses	Estimated Fair Value					
Available For Sale:												
Obligations of U.S. government agencies and corporations	\$	24,612	\$	12	\$	(408)	\$ 24,216					
Obligations of states and political subdivisions		8,347		_		(396)	7,951					
Federal agency mortgage-backed securities		21,513		164		(256)	21,421					
Federal agency collateralized mortgage obligations		855		6		(7)	854					
Other debt securities		1,253		1		(32)	1,222					
Money market mutual fund		27					27					
Total investment securities available for sale	\$	56,607	\$	183	\$	(1,099)	\$ 55,691					
Held To Maturity:												
Obligations of states and political subdivisions	\$	11,005	\$	1	\$	(578)	\$ 10,428					
Total held to maturity	\$	11,005	\$	1	\$	(578)	\$ 10,428					

	As of December 31, 2012											
	A	mortized Cost	Ur	Gross realized Gains (Dollars in	Un L	Gross realized Losses ands)		mated Fair Value				
Available For Sale:						,						
Obligations of U.S. government agencies and corporations	\$	1,000	\$	1	\$	_	\$	1,001				
Obligations of states and political subdivisions		11,304		585		(32)		11,857				
Federal agency mortgage-backed securities		3,552		129		_		3,681				
Money market mutual fund		140		_		_		140				
Total investment securities available for sale	\$	15,996	\$	715	\$	(32)	\$	16,679				

There were no securities classified as held to maturity as of December 31, 2012.

Other-than-temporary impairment, if any, is separated into (a) the amount of the total other-than-temporary impairment related to a decrease in cash flows expected to be collected from the debt security (the credit loss) and (b) the amount of the total other-than-temporary impairment related to all other factors. The amount of the total other-than-temporary impairment related to the credit loss is recognized in earnings. The amount of the total other-than-temporary impairment related to all other factors is recognized in other comprehensive income.

As of September 30, 2013, management believes that the estimated fair value of the securities disclosed above is primarily dependent upon the movement in market interest rates particularly given the minimal inherent credit risk associated with the issuers of these securities.

The impairment in the available for sale investment portfolio totaled \$1.1 million as of September 30, 2013 with a total fair value of \$55.7 million; while impairment in the held to maturity portfolio totaled \$578 thousand with a total fair value of \$10.4 million. The unrealized losses in these portfolios are attributable to the increase in interest rates that occurred in the second quarter of 2013 and are not the result of deteriorating credit within any investment category. Investment rates at September 30, 2013 are comparable to June 30, 2013.

Securities issued by states and political subdivisions are all rated investment grade. Each holding is reviewed quarterly for impairment by management and our investment advisor. All mortgage backed securities and collateralized mortgage obligations are issued by U.S. government sponsored agencies; there are no holdings of private label mortgage backed securities or securities rated "Alt-A" or "Subprime".

Although the fair value will fluctuate as market interest rates move, management believes that these fair values will recover as the underlying portfolios mature. As of September 30, 2013, there were 19 obligations of U.S. government agencies and corporations, 41 obligations of states and political subdivisions, 8 federal agency mortgage-backed securities, 1 federal agency collateralized mortgage obligation and 10ther debt security which were in an unrealized loss position. The Company evaluates a variety of factors in concluding whether securities are other-than-temporarily impaired. These factors include, but are not limited to, the type and purpose of the bond, the underlying rating of the bond issuer, and the presence of credit enhancements (i.e. state guarantees, municipal bond insurance, collateral requirements, etc.). One state and political subdivision security has been in a continuous unrealized loss position for twelve months or longer as of September 30, 2013. At that date, the current amortized cost and market value of this security was \$520 thousand and \$491 thousand, respectively, or an unrealized loss of \$29 thousand. The Company does not intend to sell any of these securities and it is unlikely that it will be required to sell any of these securities before recovery. Management does not believe any individual unrealized loss as of September 30, 2013 represents an other-than-temporary impairment. There were no individual securities in a continuous unrealized loss position for twelve months or longer as of the year ended December 31, 2012.

For the three and nine months ended September 30, 2012 net gains of \$57 thousand and \$422 thousand were realized from the sale of available for sale securities. There were no realized gains or losses for the three and nine months ended September 30, 2013.

Securities with an estimated fair value of \$42.1 million were pledged at September 30, 2013 to secure public fund deposits. There were no securities pledged for public fund deposits by the Bank as of December 31, 2012. In addition, securities pledged to secure borrowings by the Bank totaled \$117 thousand and \$4.7 million as of September 30, 2013 and December 31, 2012, respectively.

The amortized cost and fair value of securities as of September 30, 2013 by contractual maturity are shown below. Certain of these investment securities have call features which allow the issuer to call the security prior to its maturity date at the issuer's discretion.

		September	30, 2013		September 3	0, 2013				
	A	vailable for Sa	ale Securities		Held to Ma	turity				
	Amo	rtized Cost	Fair Value	Amo	Amortized Cost Fair					
		(Dollars in tl	nousands)		(Dollars in the	ousands	<u>;)</u>			
Due within one year	\$	251	\$ 251	\$	_	\$	_			
Due after one year through five years		13,505	13,358		_		_			
Due after five years through ten years		19,188	18,795		1,594		1,537			
Due after ten years		23,636	23,260		9,411		8,891			
		56,580	55,664		11,005	1	10,428			
Money market mutual fund		27	27							
Total	\$	56,607	\$ 55,691	\$	\$ 1	10,428				

#### Note 6—Loans Receivable and Related Allowance for Loan Losses

Loans receivable consist of the following at September 30, 2013 and December 31, 2012. For presentation, originated loans exclude loans acquired through the merger with Affinity consummated on February 28, 2013, and acquired loans include loans acquired through the merger with Affinity as of this same date.

	September 30, 2013 (Dollars in the	December 31, 2012 nousands)
Commercial:		
Commercial and industrial	\$ 79,038	\$ 62,366
Commercial mortgage	139,287	93,775
Commercial construction	3,671	4,112
Total commercial	221,996	160,253
Residential mortgage loans	56,780	49,354
Consumer:		
Home equity lines of credit	31,286	20,654
Other consumer loans	22,464	14,298
Total consumer	53,750	34,952
Total loans	332,526	244,559
Allowance for loan losses	(2,236)	(2,460)
Net deferred loan fees	(329)	(284)
Total loans receivable, net	\$ 329,961	\$ 241,815
Originated loans	\$ 278,843	\$ 244,559
Acquired loans	53,683	
Total loans	\$ 332,526	\$ 244,559

The Bank's loans consist of credits to borrowers spread over a broad range of industrial classifications. The largest concentrations of loans are to lessors of nonresidential buildings and lessors of residential buildings and dwellings. As of September 30, 2013, these loans totaled \$62.6 million and \$42.3 million, respectively, or 18.8% and 12.7%, respectively, of the total loans outstanding. As of December 31, 2012, these same classifications of loans totaled \$48.1 million and \$27.6 million, respectively, or 19.7% and 11.3%, respectively, of the total loans outstanding at that time. These credits were subject to normal underwriting standards and did not present more than the normal amount of risk assumed by the Bank's other lending activities. Management believes this concentration does not pose abnormal risk when compared to the risk it assumes in other types of lending. The Bank has no other concentration of loans which exceeds 10% of total loans.

The following tables summarize the activity in the allowance for loan losses by loan class for the three and nine months ended September 30, 2013 and 2012:

Total loans	Unallocated	Other consumer loans	Home equity lines of credit	Residential mortgage loans	Commercial construction	Commercial mortgage	Commercial and industrial		Total acquired loans	Unallocated	Other consumer loans	Home equity lines of credit	Residential mortgage loans	Commercial construction	Commercial mortgage	Commercial and industrial	Total originated loans	Unallocated	Other consumer loans	Home equity lines of credit	Residential mortgage loans	Commercial construction	Commercial mortgage	Commercial and industrial	Total loans	Unallocated	Other consumer loans	Home equity lines of credit	Residential mortgage loans	Commercial construction	Commercial mortgage	Commercial and industrial		
\$ 2,427	878	28	51	161	10	209	\$ 1,090	Beginning Balance	<b>→</b>		I			1	1	<b>\$</b>	\$ 2,229	993	61	180	145	30		\$ 431	\$ 2,229	993	61	180	145	30	389	\$ 431	Beginning Balance	
7 <b>\$</b> (7) <b>\$</b>			-				) \$ (7) \$	For the th Septes Allowance (Dollar Charge- offs R	<u>\$ (229)</u> <u>\$</u>		I	(86)	(6)	(	(137)	s    s	\$ (9) \$		(9)					- - - -	\$ (238)			) (86)			) (137)	\$   	(Dollar) Charge- offs R	For the th Septer Allowance
2 \$		1	1		1	I	1 \$	For the three months ended September 30, 2012 Allowance for Loan Losses (Dollars in thousands) Provision ge- Recoveries losses	10 \$		2			I		∞ ÷	υ <sub>2</sub>		2	1	l		,	ω <del>Σ</del>	15 \$		4	l	1	I		11 \$	(Dollars in thousands) Provision for loan Recoveries losses	For the three months ended September 30, 2013 Allowance for Loan Losses
80 \$ 2,502	78 956	2 31	(1) 50	5 166	1 11	274 483	\$	ion Ending	<u>\$</u>		(2)	86	6	1		(8) \$	11 \$ 2,236	(12) 981			14		+	(41) \$ 393	230 \$ 2,236	(12) 981		82 176	14	(22) 8		(49) \$ 393	ion Ending Balance	
\$ 2,470 \$	540	34	94	190	10	198	\$ 1,404 \$		+		I	1		1	ı	s     	\$ 2,460 \$	998	41	89	176	31	559	\$ 566 \$	\$ 2,460 \$	998	41	89	176	31	559	\$ 566 \$	Beginning ( Balance	
(397) \$	1	I	(190)		I	1	(207) \$	For the nine months ended September 30, 2012 Allowance for Loan Losses (Dollars in thousands) Procharge- Charge- Recoveries I	(232) \$	1	I	(86)	(9)	1 (	(137)	 &	(599) \$	 	(9)	(246)	(5)		(00)	(339) \$	(831) \$	1	(9)	(332)	(14)	I	(137)	339) \$	(Dollars in thousands)  Charge- offs Recoveries	For the nine months ended September 30, 2013 Allowance for Loan Losses
19 \$ 410	<u> </u>	17 (20)	<b>—</b> 146	- (24)		<b>—</b> 285	2 \$ (394)	onths ended 30, 2012 Loan Losses housands) Provision for loan eries losses	25 \$ 207		7 (7)	<b>—</b> 86	9		4	18 \$ (18)	12 \$ 363	- (17)	4 40	— 333	7 (30)	$- \qquad (23)$	_	1 \$ 165	37 \$ 570	- (17)	11 33	<b>—</b> 419	7 (21)	- (23)	_ 32	ا چ	housands) Provision for loan eries losses	onths ended 30, 2013 Loan Losses
\$ 2,502	956			166	11	483	S	Endii Balan		1	<i>'</i> )				`	s) s	\$ 2,236	7) 981			1,		+	393	\$ 2,236	9		) 176		3) 8		S	Ending Balance	

The following tables present the balance in the allowance for loan losses at September 30, 2013 and December 31, 2012 disaggregated on the basis of the Company's impairment method by class of loans receivable along with the balance of loans receivable by class disaggregated on the basis of the Company's impairment methodology:

					Septem	ber 30, 2013				
	Allo	wance	for Loan	Loss			Loans	Receivable	es	
		Ba Indiv Eva	nding lance ridually lluated	B Col	Ending Salance Electively Valuated	in thousands)	B Ind	Ending alance ividually	I Co	Ending Balance Ilectively
	Ending		for		for	Ending		luated for		luated for
	Balance		airment		pairment	Balance		pairment		pairment
Commercial and industrial	\$ 393	\$	37	\$	356	\$ 79,038	\$	1,846	\$	77,192
Commercial mortgage	454		52		402	139,287		1,627		137,660
Commercial construction	8		_		8	3,671		443		3,228
Residential mortgage loans	148		_		148	56,780		248		56,532
Home equity lines of credit	176		_		176	31,286				31,286
Other consumer loans	76				76	22,464		268		22,196
Unallocated	981				981					
Total loans	\$2,236	\$	89	\$	2,147	\$332,526	\$	4,432	\$	328,094
Commercial and industrial	\$ 393	\$	37	\$	356	\$ 69,464	\$	841	\$	68,623
Commercial mortgage	454		52		402	121,190		519		120,671
Commercial construction	8		_		8	2,839		_		2,839
Residential mortgage loans	148		_		148	48,987		_		48,987
Home equity lines of credit	176		_		176	21,531		_		21,531
Other consumer loans	76		_		76	14,832		49		14,783
Unallocated	981		_		981	_		_		_
Total originated loans	\$2,236	\$	89	\$	2,147	\$278,843	\$	1,409	\$	277,434
Commercial and industrial	\$ —	\$	_	\$	_	\$ 9,574	\$	1,005	\$	8,569
Commercial mortgage	_		_		_	18,097		1,108		16,989
Commercial construction	_		_		_	832		443		389
Residential mortgage loans	_		_		_	7,793		248		7,545
Home equity lines of credit	_		_		_	9,755		_		9,755
Other consumer loans	_		_		_	7,632		219		7,413
Total acquired loans	\$ —	\$		\$		\$ 53,683	\$	3,023	\$	50,660

	December 31, 2012  Allowance for Loan Losses Loans Receivables													
	Allo	wance	for Loan	Losse	es		Loan	s Receivable	es					
					(Dollars	in thousands)								
		Er	nding	E	inding									
			lance		alance			Ending		Ending				
			vidually		lectively			Balance		Balance				
			luated	Ev	aluated			lividually		ollectively				
	Ending		for	_	for	Ending		luated for		aluated for				
	Balance	Impa	airment	Imp	pairment	Balance		pairment	In	npairment				
Commercial and industrial	\$ 566	\$	315	\$	251	\$ 62,366	\$	6,372	\$	55,994				
Commercial mortgage	559		244		315	93,775		2,293		91,482				
Commercial construction	31		20		11	4,112		577		3,535				
Residential mortgage loans	176		37		139	49,354		1,040		48,314				
Home equity lines of credit	89		_		89	20,654		406		20,248				
Other consumer loans	41		—		41	14,298		_		14,298				
Unallocated	998			99		998 —								
<b>Total loans</b>	\$2,460	\$	616	\$	1,844	\$244,559	\$	10,688	\$	233,871				

The Bank had no loans acquired with deteriorated credit quality as of December 31, 2012.

The following tables summarize information in regard to impaired loans by loan portfolio class as of September 30, 2013 and December 31, 2012 as well as for the periods then ended, respectively:

		Sep	tember 30, 2			De	cember 31, 20	12		
		corded estment	Unpaid Principal Balance	Allo	lated wance ollars in	Inv	ecorded vestment sands)	Unpaid Principal Balance		elated owance
With no related allowance recorded:				`			ĺ			
Commercial and industrial	\$	1,596	\$ 3,081	\$	_	\$	4,635	\$ 4,707	\$	_
Commercial mortgage		1,108	1,378		_		_	_		_
Commercial construction		443	885		_		_	_		_
Residential mortgage loans		248	318		_		908	908		_
Home equity lines of credit		_	_		_		406	860		_
Other consumer loans		268	347		_		_	_		_
With an allowance recorded:										
Commercial and industrial	\$	250	\$ 250	\$	37	\$	1,737	\$ 2,120	\$	315
Commercial mortgage		519	521		52		2,293	2,329		244
Commercial construction		_	_		_		577	604		20
Residential mortgage loans		_	_		_		132	143		37
Home equity lines of credit		_	_		_		_	_		_
Other consumer loans		_	_		_		_	_		_
Total:										
Commercial and industrial	\$	1,846	\$ 3,331	\$	37	\$	6,372	\$ 6,827	\$	315
Commercial mortgage		1,627	1,899		52		2,293	2,329		244
Commercial construction		443	885		_		577	604		20
Residential mortgage loans		248	318		_		1,040	1,051		37
Home equity lines of credit		_	_		_		406	860		_
Other consumer loans		268	347		_		_	_		_
Total	\$	4,432	\$ 6,780	\$	89	\$	10,688	\$11,671	\$	616
With no related allowance recorded:										
Originated loans	\$	640	\$ 1,263	\$	_	\$	5,949	\$ 6,475	\$	_
Acquired Loans		3,023	4,746		_		<u> </u>	· ´—		_
Total		3,663	\$ 6,009	\$		\$	5,949	\$ 6,475	\$	
With an allowance recorded:										
Originated loans	\$	769	\$ 771	\$	89	\$	4,739	\$ 5,196	\$	616
Acquired Loans		_	_				_	_		—
Total	\$	769	<b>\$ 771</b>	\$	89	\$	4,739	\$ 5,196	\$	616
Total:										
Originated loans	\$	1,409	\$ 2,034	\$	89	\$	10,688	\$11,671	\$	616
Acquired Loans	Ψ	3,023	4,746	Ψ		Ψ		Ψ11,071 —	Ψ	
Total	<u>¢</u>	4,432	\$ 6,780	\$	89	Ф	10,688	\$11,671	\$	616
Tutai	<b>D</b>	7,734	φ υ,/ου	φ	07	Φ	10,000	φ11,U/I	φ	010

	Three Months Ended September 30, 2013 2012									Niı	ne Mo	nths End	led S	eptember	30,	
		20	2013 2012 Average Interest							20	13			20	12	
	Re	verage ecorded estment	In		R	verage ecorded vestment	Iı	nterest ncome ncomized	R	verage ecorded vestment	In	terest come ognized	Re	verage ecorded estment	In	terest come ognized
							(I	Oollars in	thou	isands)						
With no related allowance																
recorded:																
Commercial and industrial	\$	1,754	\$	_	\$	_	\$	_	\$	2,988	\$	8	\$	608	\$	17
Commercial mortgage		982		_		_		_		766		_		_		_
Commercial construction		468		2		_		_		375		18		_		_
Residential mortgage loans		491		_		424		8		789		6		212		22
Home equity lines of credit		255		_		246		1		496		1		293		3
Other consumer loans		236		_		_		_		174		_		_		
With an allowance recorded:																
Commercial and industrial	\$	515	\$	_	\$	5,243	\$	12	\$	744	\$	23	\$	5,350	\$	36
Commercial mortgage		464		_		650		18		1,281		_		531		56
Commercial construction		243		_		_		—		410		12		_		_
Residential mortgage loans		_		_		136		_		33		_		143		_
Home equity lines of credit		_		_		_		_		_		_		_		—
Other consumer loans		_		_		_		_		_		_		_		_
Total:																
Commercial and industrial	\$	2,269	\$	_	\$	5,243	\$	12	\$	3,732	\$	31	\$	5,958	\$	53
Commercial mortgage		1,446		—		650		18		2,047		_		531		56
Commercial construction		711		2		_		_		785		30		_		_
Residential mortgage loans		491		—		560		8		822		6		355		22
Home equity lines of credit		255		_		246		1		496		1		293		3
Other consumer loans		236								174						
Total	\$	5,408	\$	2	\$	6,699	\$	39	\$	8,056	\$	68	\$	7,137	\$	134

The following table presents nonaccrual loans by classes of the loan portfolio as of September 30, 2013 and December 31, 2012:

	September 30 2013 (Dolla	December 31, 2012 ars in thousands)
Commercial and industrial	\$ 1,846	
Commercial mortgage	1,627	
Commercial construction	301	
Residential mortgage loans	248	3 424
Home equity lines of credit	_	246
Other consumer loans	268	<b>—</b>
Total loans	\$ 4,290	\$ 4,093
		<u>, , , , , , , , , , , , , , , , , , , </u>
Commercial and industrial	\$ 841	\$ 1,130
Commercial mortgage	519	2,293
Commercial construction	_	_
Residential mortgage loans	<del>-</del>	424
Home equity lines of credit	_	246
Other consumer loans	49	_
Total originated loans	\$ 1,409	\$ 4,093
Commercial and industrial	\$ 1,005	\$
Commercial mortgage	1,108	_
Commercial construction	301	
Residential mortgage loans	248	<b>-</b>
Home equity lines of credit	_	_
Other consumer loans	219	
Total acquired loans	\$ 2,881	. \$ —

The Bank's policy for interest income recognition on nonaccrual loans is to recognize income under the cash basis when the loans are both current and the collateral on the loan is sufficient to cover the outstanding obligation to the Bank. The Bank will not recognize income if these factors do not exist. Interest that would have been accrued on non-accruing loans under the original terms but was not recognized as interest income totaled \$91 thousand and \$216 thousand for the three and nine months ended September 30, 2013 and \$32 thousand and \$145 thousand for the three and nine months ended September 30, 2012, respectively.

The following tables present the classes of the loan portfolio summarized by the aggregate pass rating and the classified ratings of special mention, substandard and doubtful within the Company's internal risk rating system as of September 30, 2013 and December 31, 2012:

	September 30, 2013						
	Pass	Special Mention (I	Substandard Dollars in thousand	<u>Doubtful</u> ls)	Total		
Commercial:				,			
Commercial and industrial	\$ 77,143	\$ —	\$ 1,895	\$ —	\$ 79,038		
Commercial mortgage	137,201	381	1,705	_	139,287		
Commercial construction	3,179		492		3,671		
Residential mortgage loans	56,518	_	262	_	56,780		
Consumer:							
Home equity lines of credit	31,081	_	205	_	31,286		
Other consumer loans	22,415		49		22,464		
Total	<u>\$327,537</u>	\$ 381	\$ 4,608	<u>\$                                    </u>	\$332,526		
Commercial:							
Commercial and industrial	\$ 68,701	\$ —	\$ 763	\$ —	\$ 69,464		
Commercial mortgage	120,212	381	597	_	121,190		
Commercial construction	2,839	_		_	2,839		
Residential mortgage loans	48,987	_	_	_	48,987		
Consumer:	,				,		
Home equity lines of credit	21,531	_	_	_	21,531		
Other consumer loans	14,783	_	49	_	14,832		
Total originated loans	\$277,053	\$ 381	\$ 1,409	<u>\$</u>	\$278,843		
Commercial:							
Commercial and industrial	\$ 8,442	\$ —	\$ 1,132	\$ —	\$ 9,574		
Commercial mortgage	16,989	_	1,108	_	18,097		
Commercial construction	340	_	492	_	832		
Residential mortgage loans	7,531	_	262	_	7,793		
Consumer:							
Home equity lines of credit	9,550	_	205	_	9,755		
Other consumer loans	7,632				7,632		
Total acquired loans	<u>\$ 50,484</u>	<u>\$                                    </u>	\$ 3,199	<u>\$</u>	\$ 53,683		
		D. J. 21 2012					
		December 31, 2012 Special					
	Pass	Mention	Substandard Pollars in thousand	<u>Doubtful</u> ls)	Total		
Commercial:				·			
Commercial and industrial	\$ 55,861	\$ 818	\$ 5,687	\$ —	\$ 62,366		
Commercial mortgage	91,482	_	2,293	_	93,775		
Commercial construction	3,535	_	577	_	4,112		
Residential mortgage loans	48,446	_	908	_	49,354		
Consumer:	_						
Home equity lines of credit	20,248	_	406	_	20,654		
Other consumer loans	14,298				14,298		
Total	<u>\$233,870</u>	\$ 818	\$ 9,871	<u>\$                                    </u>	\$244,559		

The performance and credit quality of the loan portfolio is also monitored by analyzing the age of the loans receivable as determined by the length of time a recorded payment is past due. The following tables present the classes of the loan portfolio summarized by the past due status as of September 30, 2013 and December 31, 2012:

		September 30, 2013						
		59 Days st Due		39 Days st Due	Greater Than 90 Days (Dollars i	Total Past Due n thousands)	Current	Total Loans Receivables
Commercial:						ĺ		
Commercial and industrial	\$	_	\$	_	\$1,126	\$ 1,126	\$ 77,912	\$ 79,038
Commercial mortgage		396		506	1,103	2,005	137,282	139,287
Commercial construction		_		_	_	_	3,671	3,671
Residential mortgage loans		_		_	171	171	56,609	56,780
Consumer:								
Home equity lines of credit		_		_	_	_	31,286	31,286
Other consumer loans		29		79	268	376	22,088	22,464
Total	\$	425	\$	585	\$2,668	\$ 3,678	\$328,848	\$ 332,526
Commercial:								
Commercial and industrial	\$	_	\$	_	\$ 841	\$ 841	\$ 68,623	\$ 69,464
Commercial mortgage		_		219	519	738	120,452	121,190
Commercial construction		_		_	_	_	2,839	2,839
Residential mortgage loans		_		_	_	_	48,987	48,987
Consumer:								
Home equity lines of credit		_		_	_	_	21,531	21,531
Other consumer loans		29		79	49	157	14,675	14,832
Total originated loans	\$	29	\$	298	\$1,409	\$ 1,736	\$277,107	\$ 278,843
Commercial:								
Commercial and industrial	\$	_	\$	_	\$ 285	\$ 285	\$ 9,289	\$ 9,574
Commercial mortgage		396		287	584	1,267	16,830	18,097
Commercial construction		_		_	_		832	832
Residential mortgage loans		—		_	171	171	7,622	7,793
Consumer:								
Home equity lines of credit		—		_	_		9,755	9,755
Other consumer loans					219	219	7,413	7,632
Total acquired loans	<u>\$</u>	396	\$	287	\$1,259	\$ 1,942	\$ 51,741	\$ 53,683
					Decemb	er 31, 2012		
	30	Greater 30-59 Days 60-89 Days Than 90 Total Past Total L					Total Loans	
		st Due		st Due	Days	Due n thousands)	Current	Receivables
Commercial:						ĺ		
Commercial and industrial	\$	_	\$	250	\$ 880	\$ 1,130	\$ 61,236	\$ 62,366
Commercial mortgage		412		224	1,898	2,534	91,241	93,775
Commercial construction				7			4,112	4,112
Residential mortgage loans Consumer:		_		_	424	431	48,923	49,354
Home equity lines of credit		_		_	246	246	20,408	20,654
Other consumer loans		_		31	_	31	14,267	14,298
Total	\$	412	\$	512	\$3,448	\$ 4,372	\$240,187	\$ 244,559
	<del>==</del>		_					

As of September 30, 2013 and December 31, 2012, there were no loans greater than 90 days past due and still accruing.

The Bank may grant a concession or modification for economic or legal reasons related to a borrower's financial condition that it would not otherwise consider, resulting in a modified loan which is then identified as a troubled debt restructuring ("TDR"). The Bank may modify loans through rate reductions, extensions of maturity, interest only payments, or payment modifications to better match the timing of cash flows due under the modified terms with the cash flows from the borrowers' operations. Loan modifications are intended to minimize the economic loss and to avoid foreclosure or repossession of the collateral. TDRs are considered impaired

loans for purposes of calculating the Bank's allowance for loan losses.

The Bank identifies loans for potential restructure primarily through direct communication with the borrower and evaluation of the borrower's financial statements, revenue projections, tax returns, and credit reports. Even if the borrower is not presently in default, management will consider the likelihood that cash flow shortages, adverse economic conditions, and negative trends may result in a payment default in the near future.

The following tables reflect information regarding troubled debt restructurings entered into by the Bank for each respective period:

	For the three months ended September 30, 2013				For the nine months ended September 30, 2013					
	Number of Contracts	Pre-Mo Outs Rec	odification tanding corded stments	Post-N Out Ro	Iodification standing corded estments (Dollars in	Number of Contracts thousands)	Pre-M Out Re	lodification istanding ecorded estments	Post-M Out Re	Iodification standing ecorded estments
Troubled debt restructurings:						, , , , , ,				
Commercial and										
industrial	_	\$		\$	_	_	\$	_	\$	_
Commercial mortgage	_		_		_	_		_		_
Commercial construction	_		_		_	_		_		_
Residential mortgage										
loans	1		77		77	1		77		77
Home equity lines of										
credit			_							_
Other consumer loans										
Total	1	\$	77	\$	77	1	\$	77	\$	77
		Septe Pre-Mo	mber 30, 20	12 Post-M	odification		Sep Pre-M	nine months tember 30, 20 odification	12 Post-M	Iodification
	Number of Contracts	Reco	anding orded tments	Re	standing corded stments (Dollars in	Number of Contracts	Re	standing ecorded estments	Re	standing ecorded estments
Troubled debt restructurings:					(2011410111	eno usunus,				
Commercial and										
industrial	_	\$	_	\$	_	2	\$	4,583	\$	4,183
Commercial mortgage	_		_		_	_		_		_
Commercial construction	_		_		_	_		_		_
To 11 11 1										
Residential mortgage loans	_		_		_	1		144		135
loans Home equity lines of	_		_		<u> </u>	-				
loans	_ 		_ _ _		_ 	1 1 —		695 —		135 246 —

As of September 30, 2013, two commercial loans classified as troubled debt restructurings with combined outstanding balances totaling \$78 thousand were in default and also classified as non-accrual status at September 30, 2013. Two troubled debt restructurings representing loans acquired through the Affinity merger are currently in default and classified as non-accrual; a commercial construction loan with a recorded value of \$301 thousand and a residential mortgage with a value of \$77 thousand. In addition, one home equity line of credit with an outstanding balance of \$246 thousand previously classified as troubled debt restructuring was completely charged-off in the second quarter of 2013. The home equity line of credit troubled debt restructuring as of September 30, 2012, totaling \$695 thousand was in default. No other TDR's have subsequently defaulted.

#### Note 7—Deposits

The components of deposits at September 30, 2013 and December 31, 2012 are as follows:

	Septen	nber 30, 2013	Decen	nber 31, 2012	
		(Dollars in thousands)			
Demand, non-interest bearing	\$	38,070	\$	28,176	
Demand, interest-bearing		43,402		9,392	
Money market and savings accounts		108,044		59,636	
Time, \$100 and over		45,899		33,049	
Time, other		105,420		102,790	

<u>\$ 340,835</u> <u>\$ 233,043</u>

Included in time, other at September 30, 2013 and December 31, 2012 are brokered deposits of \$27.9 million, and \$48.5 million, respectively.

At September 30, 2013, the scheduled maturities of time deposits were as follows:

	<b>September 30, 2013</b>
	(Dollars in thousands)
9/30/2014	\$ 59,894
9/30/2015	40,167
9/30/2016	23,803
9/30/2017	16,544
9/30/2018	10,899
Thereafter	12
	\$ 151,319

#### **Note 8—Shareholders' Equity**

During the initial offering period in 2005, the Company sold 2,107,500 shares of common stock at \$10.00 per share, which resulted in net proceeds of \$21.0 million, as well as warrants to purchase a total of 421,500 shares of common stock at an exercise price of \$12.50 per share with an expiration date in November 2010, five years from the date of issuance. As of February 29, 2008, in connection with the acquisition of Prestige, First Priority issued an additional 976,137 shares of common stock and warrants to purchase 195,227 shares of its common stock at an exercise price of \$12.50 per share with an expiration date in October 2012, resulting in additional equity of \$7.4 million. Subsequently, on October 28, 2010, the Company's Board of Directors authorized an extension of the expiration date of the total 616,727 warrants outstanding to December 31, 2013.

On August 1, 2008, 39,292 shares of common stock were issued to convert \$390 thousand of convertible subordinated debentures, issued in June and July 2007, which the Company elected to convert, resulting in additional equity of \$403 thousand. On December 31, 2009, 20,302 shares of restricted common stock were issued to a select group of executives of the Company under provisions of the Company's Deferred Compensation Plan which became effective January 1, 2009. Of the 20,302 restricted shares issued under this plan, 1,003 shares were forfeited during 2010 resulting in 19,299 restricted shares remaining outstanding as of December 31, 2012 and December 31, 2011. Additionally, shares of restricted common stock were issued to non-management employees throughout the Company under the Stock Compensation Program as described in Note 9, of which 5,025 shares and 1,775 shares were outstanding as of September 30, 2013 and December 31, 2012, respectively.

On February 28, 2013, in conjunction with the merger with Affinity Bancorp, Inc. and under the terms of the merger agreement, shareholders of Affinity received 0.9813 newly issued shares of First Priority common stock in exchange for each Affinity share. A total of 1,915,942 shares of First Priority common stock were issued.

Also, on February 28, 2013 and in conjunction with the merger Affinity Bancorp, Inc., First Priority issued 1,268,576 shares of common stock at an issuance price of \$5.22 per share through a private placement resulting in total proceeds of \$6.6 million, net of \$50 thousand of related issuance costs.

#### Preferred Stock Outstanding

On February 20, 2009, First Priority entered into a Letter Agreement with the Treasury (the "Purchase Agreement") as part of the Treasury's TARP Capital Purchase Program, pursuant to which the Company issued and sold, and the Treasury agreed to purchase, (i) 4,579 shares of the Company's Fixed Rate Cumulative Perpetual Preferred Stock, Series A, \$100 par value per share, having a liquidation preference of \$1,000 per share (the "Series A Preferred Stock"), and (ii) a warrant (the "Warrant) to purchase, on a net basis, up to 229 shares of the Company's Fixed Rate Cumulative Perpetual Preferred Stock, Series B, par value \$100 per share (the "Series B Preferred Stock"), with an exercise price of \$100 per share, for an aggregate purchase price of \$4.58 million in cash, less \$29 thousand in legal issuance costs. On February 20, 2009, the Treasury immediately exercised the Warrant, on a cashless basis, which resulted in the issuance of the 229 shares of the Series B Preferred Stock. The Series A and Series B Preferred Stock were recorded at fair value and will be amortized to liquidation value over a five year expected life.

On December 18, 2009, First Priority entered into an additional Purchase Agreement with the Treasury as part of the Treasury's TARP Capital Purchase Program for Small Banks, pursuant to which the Company issued and sold, and the Treasury agreed to purchase, (i) 4,596 shares of the Company's Fixed Rate Cumulative Perpetual Preferred Stock, Series C, \$100 par value per share, having a liquidation preference of \$1,000 per share (the "Series C Preferred Stock"), for an aggregate purchase price of \$4.60 million in cash, less \$8 thousand in legal issuance costs.

The Series A and Series C Preferred Stock will pay cumulative dividends at a rate of 5% per annum for the first five years and 9% per annum thereafter. The Series B Preferred Stock will pay cumulative dividends at a rate of 9% per annum. The Series A, B and C Preferred Stock have no maturity date and rank senior to common stock with respect to dividends and upon liquidation, dissolution, or winding up. The Company may redeem the Series A or Series C Preferred Stock, in whole or in part, at its liquidation preference plus accrued and unpaid dividends.

On February 8, 2013, the U.S. Department of Treasury sold its entire holdings of the Company's preferred stock as part of its ongoing efforts to wind down and recover its remaining Capital Purchase Program ("CPP") investments in financial institutions through a modified Dutch auction methodology by offering to domestic qualified institutional buyers and certain domestic institutional accredited investors an opportunity to purchase the Company's preferred stock from the Treasury. Upon final closing of the sale of these securities to private investors, the previously placed limitations on executive compensation expired. There were no additional changes to the previously existing outstanding preferred stock which resulted from the sale to private investors.

#### **Note 9—Stock Compensation Program**

In 2005, the Company adopted the 2005 Stock Compensation Program, which was amended at the Company's annual meeting on

April 23, 2009 as the 2009 Stock Compensation Program (the "Program") and further amended effective March 18, 2010. The Program allows equity benefits to be awarded in the form of Incentive Stock Options, Compensatory Stock Options or Restricted Stock. The Program authorizes the Board of Directors to grant options up to an aggregate maximum of 825,000 shares to officers, other employees and directors of the Company. An additional 382,957 shares were authorized for grant under this plan as a result of the merger with Affinity. Only employees of the Company will be eligible to receive Incentive Stock Options and such grants are subject to the limitations under Section 422 of the Internal Revenue Code.

All stock options granted under the Program fully vest in four years from the date of grant (or potentially earlier upon a change of control) and terminate ten years from the date of the grant. The exercise price of the options granted is the fair value of a share of common stock at the time of the grant, with a minimum exercise price of \$10 per share for shares issued prior to March 18, 2010. Effective March 18, 2010, the Company's stock compensation program was amended to eliminate the minimum exercise price.

A summary of stock option activity for the nine months ended September 30, 2013 is presented below:

	Shares	Weighted Average Exercise Price
Outstanding at beginning of period	712,350	\$ 8.87
Granted during period	_	_
Acquired in merger with Affinity	132,112	8.49
Forfeited/cancelled during period	(2,609)	9.67
Expired	(30,666)	6.52
Outstanding at end of period (1)	811,187	\$ 8.89
Exercisable at end of period (1)	608,687	\$ 9.86

<sup>(1)</sup> Included in options outstanding and exercisable at September 30, 2013 are 100,000 organizer options, with an exercise price of \$10.00 per share, exchanged as part of the 2008 acquisition of Prestige which were issued outside of the Program.

On September 30, 2013 the weighted average remaining contractual life of all outstanding stock options was 4.2 years and exercisable options was 3.0 years. Options outstanding and exercisable options at September 30, 2013 had no intrinsic value.

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model. There were no options granted in the nine months ending September 30, 2013, other than options granted in conjunction with the merger of Affinity.

Under the terms of the merger agreement, each Affinity option became fully vested and was exchanged for a grant of 0.9813 FPFC options, with an adjusted exercise price to reflect the exchange ratio and maintains the same expiration date as the original option. As a result, 132,112 options to purchase common shares of FPFC were issued with an average exercise price of \$8.49 and a remaining contractual term of 3.2 years.

These options were valued at the date of the merger at \$44 thousand based on the following weighted average assumptions:

	Septembe	r 30, 2013
Dividend yield		0.0%
Expected life	2	.6 years
Expected volatility		33%
Risk-free interest rate		0.38%
Weighted average fair value	\$	0.36
FPFC stock price at date of issuance	\$	5.22

The dividend yield assumption is based on the Company's history and expectation of dividend payouts. Due to the Company's lack of sufficient historical exercise data and the limited period of time for which shares have been issued, the "simplified" method is used to determine the expected life of options, calculated as the average of the sum of the vesting term and original contractual term for all periods presented. In valuing Affinity options, an expected life was calculated assuming all options expire with a three year expiration date expire at expiration date; otherwise, the expected expiration date is the average of three years and the expiration date. The expected volatility percentage is based on the average expected volatility of similar public financial institutions in the Company's market area. The risk-free interest rates for periods within the contractual life of the awards are based on the U.S. Treasury yield curve in effect at the time of the grant.

As of September 30, 2013, there was \$177 thousand of unrecognized compensation cost related to non-vested stock options granted after January 1, 2007. That cost is expected to be recognized over a weighted average period of 1.7 years. There was no tax benefit recognized related to this stock-based compensation.

Restricted Stock grants fully vest three years from the date of grant (or potentially earlier upon a change of control), subject to the recipient remaining an employee of the Company. Upon issuance of the shares, resale of the shares is restricted during the vesting period, during which the shares may not be sold, pledged, or otherwise disposed of. Prior to the vesting date and in the event the recipient terminates association with Company for any reasons other than death, disability or change of control, the recipient forfeits all rights to the shares that would otherwise be issued under the grant. Restricted stock awards granted under the Plan were recorded at the date of the award based on the estimated fair value of the shares. As of September 30, 2013, there was \$62 thousand of unrecognized compensation cost related to restricted stock, which will be amortized through June 30, 2016.

A summary of restricted stock award activity is presented below for the nine months ended September 30, 2013:

	Shares
Outstanding at beginning of period (1)	21,074
Granted during year	3,625
Forfeited/cancelled during year	(375)
Outstanding at end of period	24,324

<sup>(1)</sup> Included in outstanding restricted stock are 19,299 grants issued as part of the 2009 Deferred Compensation Plan

#### Note 10—Financial Instruments with Off-Balance Sheet Risk

The Company is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit. Such commitments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated balance sheet.

The Company's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit is represented by the contractual amount of those instruments. The Company uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments.

At September 30, 2013 and December 31, 2012, outstanding commitments to extend credit consisting of total unfunded commitments under lines of credit were \$74.4 million and \$53.7 million, respectively. In addition, as of each of these dates, there were \$1.3 million of performance standby letters of credit outstanding, and as of September 30, 2013, \$1.3 million of financial standby letters of credit. There were no financial standby letters of credit outstanding as of December 31, 2012.

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. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements.

Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. The Bank evaluates each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank upon extension of credit, is based on management's credit evaluation. Collateral held varies but may include personal or commercial real estate, accounts receivable, inventory and equipment.

In addition, as of September 30, 2013 and December 31, 2012 the Bank pledged \$199 thousand of deposit balances at a correspondent bank to support a \$199 thousand letter of credit issued by the correspondent on behalf of a customer of the Bank. This transaction is fully secured by the customer through a pledge of the customer's deposits at the Bank. Also, as of September 30, 2013, the Bank had outstanding a financial standby letter of credit, which was collateralized by a pledge of Bank assets at a correspondent bank totaling \$512 thousand.

## **Note 11—Regulatory Matters**

The Bank is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet the minimum capital requirements can initiate certain mandatory and possibly additional discretionary-actions by regulators that, if undertaken, could have a direct material effect on the Bank's consolidated financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of the Bank's 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.

Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios (set forth below) of total and Tier 1 capital (as defined in the regulations) to risk-weighted assets and of Tier 1 capital to average assets. Management believes, as of September 30, 2013, that the Company and the Bank meet all capital adequacy requirements to which it is subject.

The Bank's capital amounts and ratios at September 30, 2013 and December 31, 2012 are presented below:

	Actu Amount	al Ratio	Minimum Capital Requirement Amount Ratio (Dollars in thousands)		Capitalized Prompt Con Action Pro Amount	under rective
September 30, 2013						
Total capital (to risk-weighted assets)	\$41,488	12.96%	<b>\$≥25,601</b>	≥8.0%	<b>\$≥32,002</b>	≥10.0%
Tier 1 capital (to risk-weighted assets)	39,217	12.25	≥12,801	≥4.0	≥19,201	≥6.0
Tier 1 capital (to total assets)	39,217	9.54	≥16,445	≥4.0	≥20,556	≥5.0
December 31, 2012	,					
Total capital (to risk-weighted assets)	\$28,073	12.48%	\$≥18,054	≥8.0%	\$22,568	≥10.0%
Tier 1 capital (to risk-weighted	25,703	11.39	≥9,027	≥4.0	≥13,541	≥6.0
assets) Tier 1 capital (to total assets)	25,703	9.40	≥10,934	≥4.0	≥13,668	≥5.0

To be Well

First Priority's ability to pay cash dividends is dependent on receiving cash in the form of dividends from First Priority Bank. However, certain restrictions exist regarding the ability of First Priority Bank to transfer funds to First Priority in the form of cash dividends. All dividends are currently subject to prior approval of the Pennsylvania Department of Banking and Securities and the FDIC and are payable only from the undivided profits of First Priority Bank, with the exception of an exemption enacted by the Pennsylvania Department of Banking and Securities which allows the Bank to pay dividends related to the preferred stock originally issued under the U.S. Department of the Treasury's Troubled Asset Relief Program—Capital Purchase Program. Additionally, any payment of dividends by First Priority, including dividends on the aforementioned preferred stock, requires prior approval of the Federal Reserve Bank when net income for the past four quarters is not sufficient to fund the dividend payments over that same period or when such payment would negatively impact capital adequacy of the Company.

The Company's capital amounts and ratios are similar to those of the Bank.

## Note 12—Fair Value Measurements and Fair Values of Financial Instruments

Management uses its best judgment in estimating the fair value of the Bank's financial instruments; however, there are inherent weaknesses in any estimation technique. Therefore, for substantially all financial instruments, the fair value estimates herein are not necessarily indicative of the amounts the Company could have realized in a sales transaction on the dates indicated. The estimated fair value amounts have been measured as of September 30, 2013 and December 31, 2012 and have not been re-evaluated or updated for purposes of these financial statements subsequent to those respective dates. As such, the estimated fair values of these financial instruments subsequent to the respective reporting dates may be different than the amounts reported at each period end.

The Company uses fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. In accordance with FASB ASC Topic 820—Fair Value Measurements, the fair value of a financial instrument is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value is best determined based upon quoted market prices. However, in some instances, there are no quoted market prices for the Company's various financial instruments. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Accordingly, the fair value estimates may not be realized in an immediate settlement of the instrument.

The recent fair value guidance provides a consistent definition of fair value, which focuses on exit price in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions. If there has been a significant decrease in the volume and level of activity for the asset or liability, a change in valuation technique or the use of multiple valuation techniques may be appropriate. In such instances, determining the price at which willing market participants would transact at the measurement date under current market conditions depends on the facts and circumstances and requires the use of significant judgment. The fair value is a reasonable point within the range that is most representative of fair value under current market conditions.

FASB ASC Topic 820 establishes a fair value hierarchy that prioritizes the inputs to valuation methods used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy under FASB ASC Topic 820 are as follows:

Level 1: Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities.

Level 2: Quoted prices in markets that are not active, or inputs that are observable either directly or indirectly, for substantially the full term of the asset or liability.

*Level 3*: Prices or valuation techniques that require inputs that are both significant to the fair value measurement and unobservable (i.e., supported with little or no market activity).

An asset's or liability's level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement.

For financial assets measured at fair value on a recurring basis, the fair value measurements by level within the fair value hierarchy used at September 30, 2013 and December 31, 2012 are as follows:

<u>Description</u>	Fair Value	(Level 1) Quoted Prices in Active Markets for <u>Identical Assets</u> (Dollars in t	(Level 2) Significant Other Observable Inputs housands)	(Level 3) Significant Unobservable Inputs
As of September 30, 2013:		(		
Investment securities available for sale:				
Obligations of U.S. government agencies and				
corporations	\$ 24,216	\$ —	\$ 24,216	\$ —
Obligations of states and political subdivisions	7,952	_	7,952	_
Federal agency mortgage-backed securities	21,421	_	21,421	_
Federal agency CMO's	853	_	853	_
Other debt securities	1,222	_	1,222	_
Money market mutual fund	27	27		
Total assets measured at fair value on a recurring basis	\$ 55,691	\$ 27	\$ 55,664	<u> </u>
As of December 31, 2012:				
Investment securities available for sale:				
Obligations of U.S. government agencies and				
corporations	\$ 1,001	\$ —	\$ 1,001	\$ —
Obligations of states and political subdivisions	11,857	_	11,857	_
Agency mortgage-backed securities	3,681	_	3,681	_
Money market mutual fund	140	140		
Total assets measured at fair value on a recurring basis	\$ 16,679	\$ 140	\$ 16,539	<u>\$</u>

For financial assets measured at fair value on a nonrecurring basis, the fair value measurements by level within the fair value hierarchy used at September 30, 2013 and December 31, 2012 are as follows:

<u>Description</u>	<u>Fair Value</u>	(Level 1) Quoted Prices in Active Markets for Identical Assets (Dollars in	(Level 2) Significant Other Observable Inputs thousands)	(Level 3) Significant Unobservable Inputs
As of September 30, 2013:				
Impaired loans, net	\$ 4,343	\$ —	\$ —	\$ 4,343
Other real estate owned	907	_	_	907
Repossessed assets	75			75
Total assets measured at fair value on a nonrecurring basis	\$ 5,325	\$ <u> </u>	\$ —	\$ 5,325
As of December 31, 2012:		·		
Impaired loans	\$ 10,072	\$ —	\$ —	\$ 10,072
Other real estate owned	184			184
Total assets measured at fair value on a nonrecurring basis	\$ 10,256	\$	\$ —	\$ 10,256

Management generally uses a discounted appraisal technique in valuing impaired assets, resulting in the discounting of the collateral values underlying each impaired asset. A discounted tax assessment rate has been applied for smaller assets to determine the discounted collateral value. All impaired loans are classified as Level 3 in the fair value hierarchy. Collateral may be real estate and/or business assets. Impaired loans are reviewed and evaluated on at least a quarterly basis for additional impairment.

Quantitative information about Level 3 fair value measurements at September 30, 2013 is included in the table below:

	 Value n thousands)	Valuation Techniques	Unobservable Inputs	Estimated Ratings (Weighted Average) (3)
Impaired loans		Appraisal of real	Appraisal	0%-20%
	\$ 4,343	estate collateral (1)	adjustments(2)	(6.20%)
		Valuation of business assets used as collateral(1)	Valuation adjustments(2)	25%-30%
			Liquidation expenses	5%-10% (6.91%)
Other real estate owned		Appraisal of	Appraisal	0%-90%
	\$ 907	collateral(1)	adjustments(2)	(20.32%)
			Liquidation	0%-35%
			expenses	(10.09%)

Quantitative information about Level 3 fair value measurements at December 31, 2012 is included in the table below:

	 ir Value in thousands)	Valuation Techniques	Unobservable Inputs	Ratings (Weighted Average) (3)
Impaired loans	\$ 10,072	Appraisal of real estate collateral (1)	Appraisal adjustments(2)	0%-15% (8.6%)
		Valuation of business assets used as collateral(1)	Valuation adjustments(2)	25%-30%
			Liquidation	5%-10%

			expenses	(9.9%)
Other real estate owned		Appraisal of	Appraisal	
	\$ 184	collateral(1)	adjustments(2)	None
			Liquidation	5%-10%
			expenses	(8.0%)

- (1) Fair Value is generally determined through independent appraisals of the underlying collateral, which include Level 3 inputs that are not identifiable.
- (2) Appraisals may be adjusted by management for qualitative factors such as economic conditions and estimated liquidation expenses.
- (3) The range and weighted average of qualitative factors such as economic conditions and estimated liquidation expenses are presented as a percent of the appraised value.

Valuation of real estate collateral may be discounted based on the age of the existing appraisal. No discounts are taken for recent appraisals. Valuations related to business assets used as collateral are typically discounted more heavily due to the inherent level of uncertainty in determining the fair value of these types of assets.

Real estate properties acquired through, or in lieu of, foreclosure are to be sold and are carried at fair value less estimated cost to sell. Fair value is based upon independent market prices or appraised value of the property. These assets are included in Level 3 fair value based upon the lowest level of input that is significant to the fair value measurement.

The following information should not be interpreted as an estimate of the fair value of the entire Company since a fair value calculation is only provided for a limited portion of the Company's assets and liabilities. Due to a wide range of valuation techniques and the degree of subjectivity used in making the estimates, comparisons between the Company's disclosures and those of other companies may not be meaningful.

The following methods and assumptions were used to estimate the fair values of the Company's financial instruments at September 30, 2013 and December 31, 2012:

## **Cash and Cash Equivalents**

The carrying amounts reported in the balance sheet for cash and short-term instruments approximate those assets' fair values.

#### **Securities**

The fair value of securities available for sale (carried at fair value) and held to maturity (carried at amortized cost) are determined by obtaining quoted market prices on nationally recognized securities exchanges (Level 1), or matrix pricing (Level 2), which is a mathematical technique used widely in the industry to value debt securities without relying exclusively on quoted market prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted prices. For certain securities which are not traded in active markets or are subject to transfer restrictions, valuations are adjusted to reflect illiquidity and/or non-transferability, and such adjustments are generally based on available market evidence (Level 3). In the absence of such evidence, management's best estimate is used. Management's best estimate consists of both internal and external support on certain Level 3 investments. Internal cash flow models using a present value formula that includes assumptions market participants would use along with indicative exit pricing obtained from broker/dealers (where available) were used to support fair values of certain Level 3 investments, if applicable.

#### Loans Receivable

The fair values of loans are estimated using discounted cash flow analyses, using market rates at the balance sheet date that reflect the credit and interest rate-risk inherent in the loans. Projected future cash flows are calculated based upon contractual maturity or call dates, projected repayments and prepayments of principal.

# **Impaired Loans**

Impaired loans are those that are accounted for under FASB ASC Topic 310, "Receivables", in which the Company has measured impairment generally based on the fair value of the loan's collateral. Fair value is generally determined based upon independent third-party appraisals of the properties, or discounted cash flows based upon the expected proceeds. These assets are included as Level 3 fair values, based upon the lowest level of input that is significant to the fair value measurements. Of the total impaired loan portfolio at September 30, 2013 totaling \$4.4 million, \$769 thousand of originated loans were carried at cost with a fair value of \$680 thousand and a specific reserve allocation of \$89 thousand; \$640 thousand of originated loans were carried at cost with no specific reserve allocation as the fair value of the collateral exceeded the carrying value; and \$3.0 million of acquired loans were carried at fair value. As of December 31, 2012 total impaired loans were \$10.7 million, net of a valuation allowance of \$616 thousand.

## **Other Real Estate Owned**

Other real estate owned consists of properties acquired as a result of accepting a deed in lieu of foreclosure, foreclosure or through other means related to collateral on Bank loans. Costs relating to the development or improvement of assets are capitalized, and costs relating to holding the property are charged to expense. The Company had \$907 thousand and \$184 thousand of other real estate owned at September 30, 2013 and December 31, 2012, respectively. Fair value is generally determined based upon independent third-party appraisals of the properties.

## **Repossessed Assets**

Repossessed assets consist of personal property, specifically manufactured housing, that has been acquired for debts previously contracted and are included in other assets on the balance sheet. Costs relating to these assets are charged to expense. The Company had \$75 thousand of repossessed assets as of September 30, 2013. There were no repossessed assets at December 31, 2012.

## **Restricted Investment in Bank Stock**

The carrying amount of restricted investment in bank stock approximates fair value, and considers the limited marketability of such securities.

# **Accrued Interest Receivable and Payable**

The carrying amount of accrued interest receivable and accrued interest payable approximates fair value.

## **Deposit Liabilities**

The fair values disclosed for demand deposits (interest and noninterest checking), money market and savings accounts are, by definition, equal to the amount payable on demand at the reporting date (i.e., their carrying amounts). Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered in the market to the maturities of the time deposits.

#### **Short-Term Borrowings**

The carrying amounts of short-term borrowings approximate their fair values.

# **Long-Term Debt**

Fair values of FHLB advances are estimated using discounted cash flow analysis, based on quoted prices for new FHLB advances with similar credit risk characteristics, terms and remaining maturity. These prices obtained from this active market represent a market value that is deemed to represent the transfer price if the liability were assumed by a third party.

#### **Off-Balance Sheet Financial Instruments**

Fair values for the Company's off-balance sheet financial instruments (lending commitments and letters of credit) are based on fees currently charged in the market to enter into similar agreements, taking into account, the remaining terms of the agreements and the counterparties' credit standing.

At September 30, 2013 and December 31, 2012, the estimated fair values of the Company's financial instruments were as follows:

	September 30, 2013						
	Carrying Amount	Fair Value (Do	Level 1	Level 2	Level 3		
Assets:							
Cash and cash equivalents	\$ 19,082	\$ 19,082	\$ 19,082	\$ —	\$ —		
Securities available for sale	55,691	55,691	27	55,664	_		
Securities held to maturity	11,005	10,428	_	10,428	_		
Loans receivable, net	329,961	336,641	_	_	336,641		
Restricted stock	2,461	2,461		2,461	_		
Accrued interest receivable	1,423	1,423	_	1,423	_		
Liabilities:							
Deposits	340,835	342,183	_	342,183	_		
Short-term borrowings	26,875	26,875	_	26,875	_		
Long-term debt	11,000	10,806	_	10,806	_		
Accrued interest payable	460	460	_	460	_		
Off-balance sheet credit related instruments:							
Commitments to extend credit	_						

		December 31, 2012						
	Carrying Amount	Fair Value (D	Level 1	Level 2	Level 3			
Assets:								
Cash and cash equivalents	\$ 11,016	\$ 11,016	\$ 11,016	\$ —	\$ —			
Securities available for sale	16,079	16,679	140	16,539	_			
Loans receivable, net	241,815	245,493	_	_	245,493			
Restricted stock	1,337	1,337	_	1,337	_			
Accrued interest receivable	1,040	1,040	_	1,040	_			
Liabilities:								
Deposits	233,043	235,563	_	235,563	_			
Long-term debt	13,000	12,902	_	12,902	_			
Accrued interest payable	378	378	_	378	_			
Off-balance sheet credit related instruments:								
Commitments to extend credit	_	_	_	_	_			

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

The following discussion summarizes First Priority's results of operations and highlights material changes for the three and nine months ended September 30, 2013 and 2012, and its financial condition as of September 30, 2013 and December 31, 2012. This discussion is intended to provide additional information about the significant changes in the results of operations presented in the accompanying consolidated financial statements for First Priority and its wholly owned subsidiary, First Priority Bank. First Priority's consolidated financial condition and results of operations consist essentially of First Priority Bank's financial condition and results of operations. Current performance does not guarantee, and may not be indicative of, similar performance in the future.

You should read this discussion and analysis in conjunction with the unaudited consolidated financial statements for the period ended September 30, 2013 included herein as well as with the audited consolidated financial statements and the accompanying footnotes for the year ended December 31, 2012, included in the Company's Form 10-K filed with the Securities and Exchange Commission.

This discussion and analysis of financial condition and results of operations contains forward-looking statements that involve risks and uncertainties, such as First Priority's plans, objectives, expectations and intentions. Therefore, this analysis should be read in conjunction with the "Cautionary Statement Regarding Forward-Looking Statements" presented elsewhere in this document.

#### **Overview**

The following table sets forth selected measures of First Priority's financial position or performance for the dates or periods indicated.

As of and for the years ended December 31,		
2012	2011	
ousands)		
.0,673 \$	10,848	
753	70	
5,146 2	285,350	
14,275 2	40,115	
33,043 2	45,736	
1	ended December 2012	

<sup>(1)</sup> Total revenue equals net interest income plus non-interest income

Like most financial institutions, First Priority derives the majority of its income from interest it receives on its interest-earning assets, such as loans and investments. First Priority's primary source of funds for making these loans and investments is its deposits, on which it pays interest. Consequently, one of the key measures of First Priority's success is its amount of net interest income, or the difference between the income on its average interest-earning assets and the expense on its average interest-bearing liabilities, such as deposits and borrowings. Another key measure is the spread between the yield First Priority earns on these average interest-earning assets and the rate it pays on its average interest-bearing liabilities, which is called its net interest spread.

There are risks inherent in all loans, and First Priority maintains an allowance for loan losses to absorb probable losses on existing loans that may become uncollectible. This allowance is maintained by charging a provision for loan losses against operating earnings. A detailed discussion of this process, as well as several tables describing the allowance for loan losses is included.

In addition to earning interest on its loans and investments, First Priority earns income through other sources, such as fees and other charges to its banking customers and income from providing wealth management services, as well as net gains or losses realized from the sale of assets. The various components of non-interest income, as well as non-interest expense, are described in this section.

## Income Statement Review

First Priority's results of operations are affected by five major elements: (1) net interest income, or the difference between interest income earned on loans and investments and interest expense paid on deposits and borrowed funds; (2) the provision for loan losses, or the amount added to the allowance for loan losses to provide reserves for inherent losses on loans; (3) non-interest income, consisting of income from wealth management services, fees and other charges to our banking customers, and net gains or losses realized from the sale of assets; (4) non-interest expense, which consists primarily of salaries, employee benefits and other operating expenses; and (5) income taxes, including deferred taxes, when applicable. Each of these major elements is reviewed in more detail in the following discussion.

## Critical Accounting Policies

First Priority has adopted various accounting policies that govern the application of accounting principles generally accepted in the United States of America and that are consistent with general practices within the banking industry in the preparation of its consolidated financial statements. First Priority's significant accounting policies are described in Note 1 of the Unaudited Notes to Consolidated Financial Statements.

Certain accounting policies involve significant judgments and assumptions by First Priority that have a material impact on the carrying value of certain assets and liabilities. First Priority considers these accounting policies to be critical accounting policies. The judgment and assumptions used are based on historical experience and other factors, which First Priority believes to be reasonable under the circumstances and have been reasonably consistent with prior results. Because of the nature of the judgments and assumptions made, actual results could differ from these estimates, which could have a material impact on the carrying values of its assets and liabilities and its results of operations. Material estimates that are particularly susceptible to significant change in the near term relate to investment securities impairment evaluation, impairment of restricted investments in bank stocks, the determination of the allowance for loan losses, valuation of other real estate owned, the analysis of potential impairment of goodwill, the valuation of deferred tax assets and accounting for stock-based compensation.

Investment Securities Impairment Evaluation. In estimating other-than-temporary impairment losses, management considers (1) the length of time and the extent to which the fair value has been less than cost (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. When a determination is made that an other-than-temporary impairment exists but the Company does not intend to sell the debt security and it is more likely than not that it will be required to sell the debt security prior to its anticipated recovery, the other-than-temporary impairment is separated into (a) the amount of the total other-than-temporary impairment related to a decrease in cash flows expected to be collected from the debt security (the credit loss) and (b) the amount of the total other-than-temporary impairment related to all other factors. The amount of the total other-than-temporary impairment related to the credit loss is recognized in earnings. The amount of the total other-than-temporary impairment related to all other factors is recognized in other comprehensive income. Management believes that there are no investment securities with other-than-temporary impairment for each of the reporting periods presented.

Restricted Investments in Bank Stocks. Restricted investments in bank stocks, which represents the required investment in the common stock of correspondent banks, are carried at cost and consist of stock of the Federal Home Loan Bank of Pittsburgh ("FHLB") and Atlantic Central Bankers Bank. Federal law requires a member institution of the FHLB to hold FHLB stock according to a predetermined formula. Management's determination of whether these investments are impaired is based on its assessment of the ultimate recoverability of their cost rather than by recognizing temporary declines in value.

Acquired Loans. Acquired loans are those loans acquired through the merger with Affinity. Acquired loans are initially recorded at their acquisition date fair values. The carryover of allowance for loan losses is prohibited as any credit losses in the loans are included in the determination of the fair value of the loans at the acquisition date. Fair values for acquired loans are based on a discounted cash flow methodology that involves assumptions and judgments as to credit risk, prepayment risk, liquidity risk, default rates, loss severity, payment speeds, collateral values and discount rate.

For acquired loans that are not deemed impaired at acquisition, credit discounts representing principal losses expected over the life of the loan are a component of the initial fair value. Subsequent to the acquisition date, the methods used to estimate the required allowance for loan losses for these loans is similar to originated loans. However, the Company records a provision for loan losses only when the required allowance exceeds any remaining credit discount. The remaining differences between the purchase price and the unpaid principal balance at the date of acquisition are recorded in interest income over the life of the loan.

Acquired loans that have evidence of deterioration in credit quality since origination and for which it is probable, at acquisition, that the Company will be unable to collect all contractually required payments are accounted for as impaired loans under ASC 310-30. The excess of cash flows expected at acquisition over the estimated fair value is referred to as the accretable discount and is recognized into interest income over the remaining life of the loans. The difference between contractually required payments at acquisition and the cash flows expected to be collected at acquisition is referred to as the non-accretable discount. The non-accretable discount represents estimated future credit losses expected to be incurred over the life of the loan. Subsequent decreases to the expected cash flows require the Company to evaluate the need for an allowance for loan losses on these loans. Subsequent improvement in expected cash flows result in the reversal of a corresponding amount of the non-accretable discount which the Company then reclassifies as an accretable discount that is recognized into interest income over the remaining life of the loans using the interest method.

Acquired loans that met the criteria for non-accrual of interest prior to acquisition may be considered performing upon acquisition, or in the future, regardless of whether the customer is contractually delinquent, if the Company can reasonably estimate the timing and amount of the expected cash flows on such loans and if the Company expects to fully collect the new carrying value of the loans. As such, the Company may no longer consider the loan to be non-accrual or non-performing and may accrue interest on these loans, including the impact of any accretable discount. For acquired loans that are not deemed impaired at acquisition, credit

discounts representing the principal losses expected over the life of the loan are a component of the initial fair value and amortized over the life of the asset. Subsequent to the acquisition date, the methods utilized to estimate the required allowance for loan losses for these loans is similar to originated loans, however, the Company records a provision for loan losses only when the required allowance exceeds any remaining pooled discounts for loans evaluated collectively for impairment.

Allowance for Loan Losses. The allowance for credit losses consists of the allowance for loan losses and the reserve for unfunded lending commitments. The allowance for loan losses represents management's estimate of losses inherent in the loan portfolio as of the balance sheet date and is recorded as a reduction to loans. The reserve for unfunded lending commitments totaling \$35 thousand and \$10 thousand as of September 30, 2013 and December 31, 2012, respectively, represents management's estimate of losses inherent in its unfunded loan commitments and is recorded in other liabilities on the consolidated balance sheet. The allowance for loan losses is increased by the provision for loan losses, and decreased by charge-offs, net of recoveries. Loans deemed to be uncollectible are charged against the allowance for loan losses, and subsequent recoveries, if any, are credited to the allowance. All, or part, of the principal balance of loans receivable are charged off to the allowance as soon as it is determined that the repayment of all, or part, of the principal balance is highly unlikely. Because all identified losses are immediately charged off, no portion of the allowance for loan losses is restricted to any individual loan or groups of loans, and the entire allowance is available to absorb any and all loan losses.

The allowance for loan losses is maintained at a level considered adequate to provide for losses that can be reasonably anticipated. Management performs a quarterly evaluation of the adequacy of the allowance. The allowance is based on the Company's past loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay, the estimated value of any underlying collateral, composition of the loan portfolio, current economic conditions and other relevant factors. This evaluation is inherently subjective as it requires material estimates that may be susceptible to significant revision as more information becomes available.

The allowance consists of specific, general and unallocated components. The specific component relates to loans that are classified as impaired. For loans that are classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value of that loan. The general component covers pools of loans by loan class including commercial loans not considered impaired, as well as smaller balance homogeneous loans, such as residential real estate, home equity and other consumer loans. These pools of loans are evaluated for loss exposure based upon historical loss rates for each of these categories of loans, adjusted for qualitative factors. These qualitative risk factors include:

- 1. Lending policies and procedures, including underwriting standards and collection, charge-off, and recovery practices.
- 2. National, regional, and local economic and business conditions as well as the condition of various market segments, including the value of underlying collateral for collateral dependent loans.
- 3. Nature and volume of the portfolio and terms of loans.
- 4. Management team with experience, depth, and knowledge in banking and in many areas of lending. Each contributes to the sound credit culture and control within the Bank.
- 5. Volume and severity of past due, classified and nonaccrual loans as well as and other loan modifications.
- 6. The Bank engages a third party to perform an independent review of the loan portfolio as a measure for quality and consistency in credit evaluation and credit decisions.
- 7. Existence and effect of any concentrations of credit and changes in the level of such concentrations.
- 8. Effect of external factors, such as competition and legal and regulatory requirements.

Each factor is assigned a value to reflect improving, stable or declining conditions based on management's best judgment using relevant information available at the time of the evaluation. Adjustments to the factors are supported through documentation of changes in conditions in a narrative accompanying the allowance for loan loss calculation.

A majority of the Bank's loans are to business owners of many types. The Bank makes commercial loans for real estate development and other business purposes required by our customers.

The Bank's credit policies determine advance rates against the different forms of collateral that can be pledged against commercial loans. Typically, the majority of loans will be limited to a percentage of their underlying collateral values such as real estate values, equipment, eligible accounts receivable and inventory. Individual loan advance rates may be higher or lower depending upon the financial strength of the borrower and/or term of the loan. The assets financed through commercial loans are used within the business for its ongoing operation. Repayment of these kinds of loans generally comes from the cash flow of the business or the ongoing conversions of assets. Commercial real estate loans include long-term loans financing commercial properties. Repayment of this kind of loan is dependent upon either the ongoing cash flow of the borrowing entity or the resale of or lease of the subject property. Commercial real estate loans typically require a loan to value ratio of not greater than 80% and vary in terms.

Residential mortgages and home equity loans are secured by the borrower's residential real estate in either a first or second lien position. Residential mortgages and home equity loans have varying loan rates depending on the financial condition of the borrower and the loan to value ratio. Residential mortgages have amortizations up to 30 years and home equity loans have maturities up to 10 years.

Other consumer loans include installment loans, car loans, and overdraft lines of credit. The majority of these loans are secured.

An unallocated component of the allowance for loan losses is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

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 of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan by loan basis for commercial and industrial loans, commercial real estate loans and commercial construction loans by either the present value of expected future cash flows discounted at the loan's effective interest rate or the fair value of the collateral if the loan is collateral dependent.

An allowance for loan losses is established for an impaired loan if its carrying value exceeds its estimated fair value. The estimated fair values of substantially all of the Company's impaired loans are measured based on the estimated fair value of the loan's collateral.

For commercial loans secured by real estate, estimated fair values are determined primarily through third-party appraisals. When a real estate secured loan becomes impaired, a decision is made regarding whether an updated certified appraisal of the real estate is necessary. This decision is based on various considerations, including the age of the most recent appraisal, the loan-to-value ratio based on the original appraisal and the condition of the property. Appraised values may be discounted to arrive at the estimated selling price of the collateral, which is considered to be the estimated fair value. The discounts also include estimated costs to sell the property.

For commercial and industrial loans secured by non-real estate collateral, such as accounts receivable, inventory and equipment, estimated fair values are determined based on the borrower's financial statements, inventory reports, accounts receivable aging or equipment appraisals or invoices. Indications of value from these sources are generally discounted based on the age of the financial information or the quality of the assets.

Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Company does not separately identify individual residential mortgage loans, home equity loans and other consumer loans for impairment disclosures, unless such loans are the subject of a troubled debt restructuring agreement.

Acquired loans are recorded at acquisition date at their acquisition date fair values, and therefore, are excluded from the calculation of loan loss reserves as of the acquisition date. To the extent there is a decrease in the present value of cash flows from the acquired impaired loans after the date of acquisition, the Company records a provision for potential losses. During the three and nine months ended September 30, 2013, the Company recorded a provision for loan losses totaling \$89 thousand for acquired impaired loans.

For acquired loans that are not deemed impaired at acquisition, credit discounts representing the principal losses expected over the life of the loan are a component of the initial fair value. Subsequent to the acquisition date, the methods utilized to estimate the required allowance for loan losses for these loans is similar to originated loans, however, the Company records a provision for loan losses only when the required allowance exceeds any remaining pooled discounts for loans evaluated collectively for impairment. During the three and nine months ended September 30, 2013, the Company recorded a provision for loan losses totaling \$118 thousand on acquired non-impaired loans.

The allowance calculation methodology includes further segregation of loan classes into risk rating categories. The borrower's overall financial condition, repayment sources, guarantors and value of collateral, if appropriate, are evaluated annually for commercial loans or when credit deficiencies arise, such as delinquent loan payments, for commercial and consumer loans. Credit quality risk ratings include regulatory classifications of special mention, substandard, doubtful and loss. Loans classified as special mention have potential weaknesses that deserve management's close attention. If uncorrected, the potential weaknesses may result in deterioration of the repayment prospects. Loans classified as substandard have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They include loans that are inadequately protected by the current sound net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans classified as doubtful have all the weaknesses inherent in loans classified substandard with the added characteristic that collection or liquidation in full, on the basis of current conditions and facts, is highly improbable.

Loans classified as a loss are considered uncollectible and are charged to the allowance for loan losses. Loans not classified are rated pass.

In addition, Federal and State regulatory agencies, as an integral part of their examination process, periodically review the Company's allowance for loan losses and may require the Company to recognize additions to the allowance based on their judgments about information available to them at the time of their examination, which may not be currently available to management. Based on management's comprehensive analysis of the loan portfolio, management believes the current level of the allowance for loan losses is adequate.

See the Allowance for Loan Losses sections related to Balance Sheet Review as of September 30, 2013 and December 31, 2012 for more information.

Other Real Estate Owned. Assets acquired through, or in lieu of, loan foreclosure are held for sale and are initially recorded at fair value less cost to sell at the date of foreclosure, establishing a new cost basis. Any write-down, at or prior to the dates the real estate is considered foreclosed, is charged to the allowance for loan losses. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of carrying amount or fair value less cost to sell. Revenue and expenses from operations and changes in the valuation allowance (write-downs) are included in other non-interest expenses. Any gain or loss upon the sale of real estate owned is charged to operations as incurred.

Goodwill. Goodwill represents the excess of the cost of an acquired entity over the fair value of the identifiable net assets acquired in accordance with the acquisition method of accounting. Goodwill is not amortized but is reviewed for potential impairment on an annual basis, or more often if events or circumstances indicate that there may be impairment. Goodwill is tested for impairment at the reporting unit level and an impairment loss is recorded to the extent that the carrying amount of goodwill exceeds its implied fair value. The Company employs general industry practices in evaluating the fair value of its goodwill. Any impairment loss related to goodwill and other intangible assets is reflected as other non-interest expense in the statement of operations in the period in which the impairment is determined. No assurance can be given that future impairment tests will not result in a charge to earnings.

*Income Taxes.* Deferred taxes are provided on the liability method whereby deferred tax assets are recognized for deductible temporary differences and deferred tax liabilities are recognized for taxable temporary differences. Temporary differences are the differences between the reported amounts of assets and liabilities and their tax basis. Deferred tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of enactment. The Company files a consolidated federal income tax return with the Bank.

The Company evaluates the carrying amount of its deferred tax assets on a quarterly basis or more frequently, if necessary, in accordance with the guidance provided in Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic 740 (ASC 740), in particular, applying the criteria set forth therein to determine whether it is more likely than not (i.e. a likelihood of more than 50%) that some portion, or all, of the deferred tax asset will not be realized within its life cycle, based on the weight of available evidence. If management makes a determination based on the available evidence that it is more likely than not that some portion or all of the deferred tax assets will not be realized in future periods a valuation allowance is calculated and recorded. These determinations are inherently subjective and dependent upon estimates and judgments concerning management's evaluation of both positive and negative evidence. In assessing the need for a valuation allowance, the Company carefully weighed both positive and negative evidence currently available. Judgment is required when considering the relative impact of such evidence. The weight given to the potential effect of positive and negative evidence must be commensurate with the extent to which it can be objectively verified.

When determining an estimate for a valuation allowance, the Company assessed the possible sources of taxable income available under tax law to realize a tax benefit for deductible temporary differences and carryforwards as defined in paragraph 740- 10-30-18. A cumulative loss in recent years is a significant piece of negative evidence that is difficult to overcome. As a result of cumulative losses in the Company's formative years and the uncertain nature of the current economic environment, the Company did not use projections of future taxable income, exclusive of reversing temporary timing differences and carryforwards, as a factor.

The Company also considers tax planning strategies which could accelerate taxable income and allow the Company to take advantage of future deductible differences. The strategy must be prudent and feasible; however, the Company does not need to have specific plans to implement the strategy, but could be an opportunity that the Company could implement in order to take advantage of net operating loss carryforwards. One such strategy would be unrealized gains which exist on available for sale securities.

Based on the analysis of available positive and negative evidence, the Company determined that a valuation allowance should be recorded as of each period presented. As of September 30, 2013, First Priority has a total net deferred tax asset of \$5.7 million (before the valuation allowance) which is fully reserved through the valuation allowance for deferred taxes. Similarly, as of December 31, 2012, the Company had a total net deferred tax asset of \$3.7 million (before the valuation allowance) which is also fully reserved through the related valuation allowance.

The incremental net deferred tax assets resulting from the merger with Affinity totaled \$1.8 million, as discussed in Note 2 – "Merger with Affinity Bancorp, Inc." Included in this net deferred tax asset, Affinity had a net operating loss carryforward for Federal tax purposes of \$1.5 million, or a \$500 thousand tax impact at the statutory federal income tax rate of 34%, which is subject to certain limitations and expires in 2028 if not fully utilized. These deferred tax asset component is fully reserved.

The most significant component of the Company's unrecognized deferred tax asset balance relates to the Company's net operating loss carryforward of \$8.8 million and \$6.9 million, respectively, or a \$3.0 million and \$2.4 million tax impact computed at the statutory federal income tax rate of 34%, respectively as of September 30, 2013 and December 31, 2012 which expire in 2026 through 2033. These deferred tax assets are fully reserved.

In regards to the acquisition of Prestige Community Bank in February, 2008, the Company acquired a NOL for tax purposes which totaled \$2.0 million, or a \$684 thousand tax impact at the statutory federal income tax rate of 34%, as of both September 30, 2013 and December 31, 2012, respectively, which is subject to certain limitations and expires in 2028 if not fully utilized. As the Company is able to utilize the acquired NOL, the impact of this reduction in the Company's tax liability is recognized as a reduction of goodwill.

Stock Based Compensation. Compensation costs related to share-based payment transactions are recognized in the financial statements over the period that an employee provides service in exchange for the award. The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model based on these management assumptions. The dividend yield assumption is based on the Company's history and expectation of dividend payouts. Due to the Company's lack of sufficient historical exercise data and the limited period of time for which shares have been issued, the "simplified" method is used to determine the expected life of options, calculated as the average of the sum of the vesting term and original contractual term for all periods presented. The expected volatility percentage is based on the average expected volatility of similar public financial institutions in the Company's market area. The risk-free interest rates for periods within the contractual life of the awards are based on the U.S. Treasury yield curve in effect at the time of the grant.

### Results of Operations

#### Income Statement Review

First Priority's results of operations are affected by five major elements: (1) net interest income, or the difference between interest income earned on loans and investments and interest expense accrued on deposits and borrowed funds (2) the provision for loan losses, or the amount added to the allowance for loan losses to provide reserves for inherent losses on loans; (3) non-interest income, consisting of income from wealth management services, fees and other charges to our banking customers, and net gains or losses realized from the sale of assets; (4) non-interest expense, which consists primarily of salaries, employee benefits and other operating expenses; and (5) income taxes, including deferred taxes, when applicable. Each of these major elements is reviewed in more detail in the following discussion.

The results of Affinity's operations are included in the Company's consolidated financial statements prospectively from the date of the merger, February 28, 2013; therefore, seven months of Affinity's operating results are included in the Company's statement of operations for the first nine months of 2013.

## Summary

For the three months ended September 30, 2013, First Priority reported a net income of \$87 thousand compared to \$218 thousand for the three months ended September 30, 2012. Reported results are before preferred dividends and amortization of a preferred warrant, totaling \$133 thousand and \$132 thousand for the three months ended September 30, 2013 and 2012, respectively, related to preferred stock originally issued to the U.S. Treasury under the TARP Capital Purchase Program during 2009. The resulting loss to common shareholders, after the preferred dividends and amortization, was \$46 thousand, or \$0.01 per basic and fully diluted common share for the three months ended September 30, 2013 compared net income of \$86 thousand, or \$0.03 per basic and fully diluted common share, for the three months ended September 30, 2012.

For the nine months ended September 30, 2013, First Priority reported a net loss of \$506 thousand compared to net income of \$551 thousand for the nine months ended September 30, 2012. After the preferred dividends and amortization of a preferred warrant, totaling \$399 thousand for each of the nine months ended September 30, 2013 and 2012, respectively, the resulting loss to common shareholders \$905 thousand, or \$0.16 per basic and fully diluted common share for the nine months ended September 30, 2013, compared to net income to common shareholders of \$152 thousand, or \$0.05 per basic and fully diluted common share, on this same basis for the nine month period ended September 30, 2012.

First Priority's reported consolidated results decreased \$1.06 million for the first nine months of 2013 compared to the same period in 2012. Included in the 2013 results are \$1.5 million of merger related costs compared to \$328 thousand for the prior year. Total revenue for the nine months ended September 30, 2013 was \$11.10 million, compared to \$7.93 million in 2012, as net interest income

in 2013 was \$10.57 million and non-interest income was \$531 thousand. Net interest income for the first nine months of 2012 was \$7.17 million and non-interest income was \$751 thousand, which included \$422 thousand of gains recorded from the sale of investment securities available for sale. The provision for loan losses was \$570 thousand for the nine months ended September 30, 2013 versus \$410 thousand for the same period in the prior year. Operating expenses were \$11.03 million, \$4.07 million higher than the \$6.96 million for the first nine months of 2012 primarily due to \$1.21 million of incremental merger related costs and incremental operating expenses related to the merger with Affinity beginning in March of this year.

#### Net Interest Income

First Priority's primary source of revenue is net interest income. Net interest income is determined by the average balances of interest-earning assets and interest-bearing liabilities and the interest rates earned and paid on these balances. The amount of net interest income recorded by First Priority is affected by the rate, mix and amount of growth of interest-earning assets and interest-bearing liabilities, the amount of interest-earning assets as compared to the amount of interest-bearing liabilities, and by changes in interest rates earned and interest rates paid on these assets and liabilities.

The following table sets forth, for the three month periods ended September 30, 2013 and 2012, information related to First Priority's average balances, yields on average assets, and costs of average liabilities. Average balances are derived from the daily balances throughout the periods indicated and yields are derived by dividing income or expense by the average balance of the corresponding assets or liabilities. Average loans are stated net of deferred costs.

	For the Three Months Ended September 30,						
		2013			2012		
	Average Balance	Interest Income/ Expense	Yield/ Rate (Dollars in t	Average Balance housands)	Interest Income/ Expense	Yield/ Rate	
Interest-earning assets:				ĺ			
Loans receivable	\$329,982	\$4,224	5.08%	\$242,654	\$3,104	5.09%	
Taxable investment securities	57,186	323	2.24%	21,067	167	3.17%	
Nontaxable investment securities	2,840	28	3.99%	3,008	31	4.17%	
Total investment securities	60,026	351	2.32%	24,075	198	3.30%	
Deposits with banks and other	9,216	20	0.88%	559	2	0.40%	
Total interest earning assets	399,224	4,595	4.57%	267,288	3,304	4.92%	
Non-interest-earning assets	14,031			7,631			
TOTAL ASSETS	\$413,255			\$274,919			
Interest-bearing liabilities:							
Demand, interest-bearing	\$ 45,623	30	0.27%	\$ 9,019	8	0.33%	
Money market and savings	108,679	102	0.37%	54,196	85	0.63%	
Time deposits	152,537	613	1.60%	142,697	698	1.95%	
Borrowed funds	25,047	34	0.53%	12,637	40	1.26%	
Total interest-bearing liabilities	331,886	779	0.93%	218,549	831	1.51%	
Non interest-bearing liabilities:							
Demand, non-interest bearing deposits	37,580			27,096			
Other liabilities	1,549			1,310			
Shareholders' equity	42,240			27,964			
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	\$413,255			\$274,919			
Net interest income/rate spread		\$3,816	3.64%		\$2,473	3.41%	
Net interest margin		<u></u>	3.79%			3.68%	

Net interest income increased 54.3%, or \$1.34 million, in the three months ended September 30, 2013 to \$3.82 million from \$2.47 million for the same period in 2012. The increase primarily resulted from growth of average interest earning assets due to the merger with Affinity. Average interest earning assets for the third quarter of 2013 increased \$131.9 million, or 49.4%, from \$267.3 million in 2012 to \$399.2 million in 2013. This increase was partially related to average loans which grew \$87.3 million, or 36.0%, from an average of \$242.7 million to \$330.0 million, while average investment balances grew \$35.9 million from an average of \$24.1 million to \$60.0 million. Average interest bearing liabilities increased \$113.3 million, or 51.8%, in 2013 to \$331.9 million in 2013 from \$218.6 million in 2012.

Net interest margin increased 11 basis points from 3.68% for the third quarter of 2012 to 3.79% for the same period in 2013. The average yield on earning assets declined 35 basis points in the current quarter compared to the prior year three month period from 4.92% to 4.57%, while the average cost of funds declined 58 basis points from 1.51% to 0.93%. Net interest spread increased 23 basis points from 3.41% to 3.64% when comparing these same periods.

The following table sets forth, for the nine month periods ended September 30, 2013 and 2012, information related to First Priority's average balances, yields on average assets, and costs of average liabilities. Non-accruing loans averaged \$4.8 million and \$6.3 million for the nine months ended September 30, 2013 and 2012, respectively.

	For the Nine Months Ended September 30,						
	2013				2012		
	Average Balance	Interest Income/ Expense	Yield/ Rate	Average Balance	Interest Income/ Expense	Yield/ Rate	
<b>T</b>			(Dollars in the	nousands)			
Interest-earning assets:	<b>#212.452</b>	<b>010 117</b>	5 100	Φ2.41.050	ΦΩ 200	5 1 407	
Loans receivable	\$312,453	\$12,115	5.18%	\$241,850	\$9,299	5.14%	
Taxable investment securities	46,063	714	2.07%	23,563	541	3.07%	
Nontaxable investment securities	2,719	84	4.13%	2,017	64	4.24%	
Total investment securities	48,782	798	2.19%	25,580	605	3.16%	
Deposits with banks and other	9,884	47	0.64%	1,799	5	0.35%	
Total interest earning assets	371,119	12,960	4.67%	269,229	9,909	4.92%	
Non-interest-earning assets	14,619			8,349			
TOTAL ASSETS	\$385,738			\$277,578			
Interest-bearing liabilities:	<del></del>			<del></del>			
Demand, interest-bearing	\$ 38,504	76	0.27%	\$ 6,542	14	0.29%	
Money market and savings	96,512	291	0.40%	54,257	264	0.65%	
Time deposits	154,209	1,896	1.64%	152,015	2,271	2.00%	
Borrowed funds	18,563	131	0.94%	9,840	186	2.53%	
Total interest-bearing liabilities	307,788	2,394	1.04%	222,654	2,735	1.64%	
Non interest-bearing liabilities:							
Demand, non-interest bearing deposits	35,401			25,863			
Other liabilities	1,477			1,247			
Shareholders' equity	41,072			27,814			
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	\$385,738			\$277,578			
Net interest income/rate spread		\$10,566	3.63%		\$7,174	3.28%	
Net interest margin			3.81%			3.56%	

Net interest income increased 47.3%, or \$3.4 million, in the first nine months of 2013 to \$10.6 million from \$7.2 million for the same period in 2012. The increase in net interest income primarily resulted from growth of average interest earning assets due to the merger with Affinity. Average interest earning assets for the first nine months of 2013 increased \$101.9 million, or 37.9%, from \$269.2 million in 2012 to \$371.1 million in 2013, primarily related to average loans which grew \$70.6 million, or 29.2%, from an average of \$241.9 million to \$312.5 million, while average investment balances grew \$23.2 million. Average interest-bearing liabilities increased \$85.1 million, or 38.2%, in 2013 to \$307.8 million in 2013 from \$222.7 million in 2012, which included increases in average interest-bearing demand deposits of \$32.0 million, \$42.2 million in money market and savings deposits and \$8.8 million in borrowings and time deposits of \$2.2 million.

Net interest margin increased 25 basis points from 3.56% for the first nine months of 2012 to 3.81% for the same period in 2013. Reflecting the declining interest rate environment, First Priority's average yield on earning assets declined 25 basis points compared to the prior year nine month period from 4.92% to 4.67%, while the average cost of funds declined 60 basis points from 1.64% to 1.04%. Average rates on money market and savings deposits declined 25 basis points and time deposit average rates declined 36 basis points in the current year nine month period compared to the prior year's first nine months. The federal funds rate remained constant throughout the year as set by the Federal Open Market Committee ("FOMC") of the Federal Reserve at a range of 0.00% to 0.25%.

Net interest spread, defined as the mathematical difference between the yield on average earning assets and the rate paid on average interest bearing liabilities, increased 35 basis points from 3.28% for the first nine months of 2012 to 3.63% for the same period in 2013. This increase in the net interest spread was impacted by the continued low rate environment and the effect of those interest rates on repricing assets and liabilities and due to the changing mix of average earning assets and average interest bearing liabilities during the two periods. Interest rates paid on new and repricing liabilities declined consistent with the lower level of market rates of interest. Net interest spread was also positively impacted by the fair value adjustments made during acquisition accounting of earning assets and interest bearing liabilities acquired in the merger with Affinity which have been adjusted to yield current market rates and costs.

## Analysis of Changes in Net Interest Income

Net interest income can also be analyzed in terms of the impact of changing interest rates and changing volume. As shown in the Changes in Net Interest Income tables below, total net interest income increased \$1.34 million when comparing the current quarter ended September 30, 2013 to the same period in 2012, of which incremental growth of balances accounted for an increase of \$1.20 million while the change in our relative rate structure resulted in an increase in net interest income of \$142 thousand. The increased volume of average earning assets provided an additional \$1.36 million in interest income, \$1.13 million provided from incremental loan balances and \$233 thousand from investment securities and deposits with banks. At the same time, however, the lower average yield on earning assets, resulted in a slight decline of interest income between the periods of \$68 thousand. From a funding perspective, the incremental interest expense related to additional volume was \$158 thousand while the lower average rates resulted in lower interest expense of \$210 thousand by comparison.

Total net interest income increased \$3.39 million for the first nine months of 2013 compared to the same period of 2012, of which incremental growth of balances accounted for an increase of \$2.82 million while the change in our relative rate structure resulted in an increase in net interest income of \$568 thousand. The increased volume of average earning assets provided an additional \$3.18 million in interest income, \$2.73 million provided from incremental loan balances and \$447 thousand from investment securities and deposits with banks. At the same time, however, the lower average yield on earning assets, resulted in a reduction of interest income between the periods of \$125 thousand. From a funding perspective, although interest-bearing liabilities increased between the two periods, the incremental growth at an overall lower average rate resulted in an increase of interest expense related to the volume of only \$352 thousand while the lower average rates resulted in lower interest expense of \$693 thousand by comparison.

The following tables sets forth the effect which varying levels of average interest-earning assets, interest-bearing liabilities and the applicable rates have had on changes in net interest income for the periods presented.

	For the Septem Inc	in Net Inter- Three Mont aber 30, 2013 crease (Decre ue to Chang ollars in thous Rate	ths Ended 8 vs. 2012 ease) e In	Changes in Net Interest Income For the Nine Months Ended September 30, 2013 vs. 2012 Increase (Decrease) Due to Change In (Dollars in thousands)  Volume Rate Net Change In		
Interest income:						
Loans receivable	\$ 1,126	\$ (6)	\$ 1,120	\$ 2,729	\$ 87	\$ 2,816
Taxable investment securities	218	(62)	156	391	(218)	173
Nontaxable investment securities	(2)	(1)	(3)	21	(1)	20
Total investment securities	216	(63)	153	412	(219)	193
Deposits with banks and other	17	1	18	35	7	42
Total interest earning assets	1,359	(68)	1,291	3,176	(125)	3,051
Interest expense:						
Demand, interest-bearing	24	(2)	22	63	(1)	62
Money market and savings	61	(44)	17	153	(126)	27
Time deposits	47	(132)	(85)	32	(407)	(375)
Borrowed funds	26	(32)	(6)	104	(159)	(55)
Total interest bearing liabilities	158	(210)	(52)	352	(693)	(341)
Change in net interest income	\$ 1,201	\$ 142	\$ 1,343	\$ 2,824	\$ 568	\$ 3,392

# Provision for Loan Losses

The allowance for loan losses is established through provisions for loan losses charged against operations. Loans deemed to be uncollectible are charged against the allowance for loan losses, and subsequent recoveries, if any, are credited to the allowance as recoveries.

The allowance for loan losses is maintained at a level considered adequate to provide for losses that can be reasonably anticipated. Management's periodic evaluation of the adequacy of the allowance is based on known or potential risks in the portfolio, adverse situations that may affect a borrower's ability to repay, the estimated value of any underlying collateral, the composition of the loan portfolio, current economic conditions and other relevant factors. This evaluation is inherently subjective as it requires material estimates that may be susceptible to significant revisions as more information becomes available or economic conditions change.

Acquired loans are initially recorded at acquisition date at their acquisition date fair values, and therefore, are excluded from the calculation of loan loss reserves as of the acquisition date. To the extent there is a decrease in the present value of cash from the acquired impaired loans after the date of acquisition, the Company records a provision for probable losses. During the nine months ended September 30, 2013, the Company recorded a provision for loan losses totaling \$207 thousand; of this amount, \$85 thousand related to a home equity line of credit secured by a residential property which the Bank acquired through a sheriff sale and moved into other real estate owned. At the time of repossession the Bank charged-off \$85 thousand based on revised estimates of the property's fair value. This loan was a credit impaired loan acquired through the merger with Affinity. In addition, a charge-off of \$137 thousand was recorded on a loan relationship whereby the borrower recently filed for bankruptcy in regards to five separate investment properties.

At the end of each quarter or more often, if necessary, First Priority analyzes the collectability of its loans and accordingly adjusts the loan loss allowance to an appropriate level. The allowance for loan losses covers estimated credit losses on individually evaluated loans that are determined to be impaired, as well as estimated credit losses inherent in the remainder of the loan portfolio. For a description of the process for determining the adequacy of the allowance for loan losses, see the "Allowance for Loan Losses" section below.

For the current quarter, the provision for loan losses increased \$150 thousand to \$230 thousand as compared to \$80 thousand for the three months ended September 30, 2012.

The provision for loan losses increased \$160 thousand for the first nine months of 2013 to \$570 thousand as compared to \$410 thousand for the nine months ended September 30, 2012. The level of provision is impacted by the adequacy of the allowance as described above, including an analysis of impaired and non-performing loans, as well as by the level of incremental loan volume and net charge-offs of loans. Total loans increased \$87.9 million when comparing September 30, 2013 to the same date in the prior year, of which \$77.4 million was related to the merger with Affinity. Net charge-offs for the nine months ended September 30, 2013 and 2012, totaled \$794 thousand and \$378 thousand, respectively. The allowance for loan losses was \$2.2 million and \$2.5 million as of September 30, 2013 and 2012, respectively, which represented 0.67% and 1.03% of total loans outstanding at each respective date. As of September 30, 2013, the allowance for loan losses related to originated loans totaled 0.80%.

#### Non-Interest Income

For the current quarter, non-interest income totaled \$253 thousand for the three months ended September 30, 2013 compared to \$167 thousand for the same period in 2012, which also included \$57 thousand of gains from the sale of investment securities available for sale. Non-interest income is comprised of wealth management fees which are principally non-recurring commissions and fees related to the sale of insurance products and annuities, service charges on deposit accounts, and other fees which First Priority Bank collects from its banking customers.

Non-interest income totaled \$531 thousand for the nine months ended September 30, 2013 compared to \$751 thousand for the same period in 2012. First Priority recorded \$422 thousand of gains from the sale of investment securities available for sale for the nine months ended September 30, 2012; there were no investment securities gains in the nine months ended September 30, 2013.

Components of non-interest income are shown in the table below:

	three mor	the nths ended nber 30, 2012 (Dollars in	Net Change 2013 vs. 2012 1 thousands)	% Change 2013 vs. 2012	nine mon	the other and th	Net Change 2013 vs. 2012 n thousands)	% Change 2013 vs. 2012
Non-Interest Income								
Wealth management fee income	\$ 158	\$ 71	\$ 87	122.5%	\$ 273	\$ 200	\$ 73	36.5%
Service charges on deposits	38	16	22	137.5	97	54	43	79.6
Other branch fees	41	15	26	173.3	107	45	62	137.8
Loan related fees	9	7	2	28.6	31	19	12	63.2
Gains on sales of investment securities	_	57	(57)	(100.0)	_	422	(422)	(100.0)
Other	7	1	6		23	11	12	109.1
Total Non-Interest Income	\$ 253	\$ 167	\$ 86	51.5%	\$ 531	\$ 751	\$ (220)	(29.3)%

## Non-Interest Expenses

For the current quarter, non-interest expenses were \$3.75 million compared to \$2.34 million for the same period in the prior year, an increase of \$1.41 million, or 60.2%. Non-interest expenses were \$11.03 million for the first nine months of 2013 compared to \$6.96 million for the same period in the prior year, an increase of \$4.07 million, or 58.4%.

The following table sets forth information related to the various components of non-interest expenses for each respective period.

		_	the three Septem 2013 (Dollars in	iber 30	0, 2012	20	Change 013 vs. 2012	% Change 2013 vs. 2012	For the nine months ended September 30,  2013 2012 (Dollars in thousands)		2	1 Change 013 vs. 2012	% Change 2013 vs. 2012	
No	on-Interest Expenses		`		ĺ					`	ŕ			
	Salaries and employee benefits	\$	1,788	\$	1,326	\$	462	34.8%	\$	5,129	\$ 4,048	\$	1,081	26.7%
	Occupancy and equipment		541		269		272	101.1		1,475	785		690	87.9
	Data processing equipment and													
	operations		250		140		110	78.6		661	385		276	71.7
	Professional fees		219		122		97	79.5		573	382		191	50.0
	Marketing, advertising and business		20		10		20	200.0		1.40	50		07	106.5
	development		39		10		29	290.0		149	52		97	186.5
	FDIC insurance assessments		94		62		32	51.6		259	192		67	34.9
	Pennsylvania bank shares tax expense		101		57		44	77.2		277	170		107	62.9
	Collateral protection expense		_		_		_	_		_	168		(168)	(100.0)
	Other real estate owned costs		118		_		118	100.0		280	_		280	100.0
	Other		278		171		107	62.6		696	454		242	53.3
			3,428		2,157		1,271	58.9%		9,499	6,636		2,863	43.1%
	Merger related costs		324		185		139	75.1		1,534	328		1,206	367.7
	Total Non-Interest Expenses	\$	3,752	\$	2,342	\$	1,410	60.2%	\$	11,033	\$ 6,964	\$	4,069	58.4%

Non-interest expenses, excluding merger related costs, increased \$1.27 million, or 58.9% in the current quarter compared to the third quarter of 2012, and increased \$2.86 million, or 43.1%, for the first nine months of 2013 compared to the same period in the prior year. The primary factors which caused this increase were primarily the result of:

- Increased operating costs in the current year related to the addition of staffing, branch offices, and other ongoing operating costs resulting from the merger with Affinity which was completed effective February 28, 2013. These expenses include the incremental costs of operating two separate core banking systems through the system conversion date in late August.
- Increased professional fees related to emphasis on resolving loan workout situations and incremental costs related to maintaining and liquidating other real estate owned.

# Highlights of significant non-interest expenses items for the third quarter, 2013 compared to the third quarter, 2012

- Salaries and employee benefits includes incremental staffing costs due to the addition of Affinity employees of approximately \$450 thousand.
- Occupancy and equipment includes costs related to the incremental branch offices of Affinity.
- Data processing equipment and operations includes approximately \$56 thousand related to costs to process Affinity's separate banking system prior to conversion in August. Additionally, the current quarter includes other incremental costs related to Affinity offices as well as higher ongoing costs related to a higher level of banking customer activity.
- Professional fees increased due to legal costs for loan workout situations, accounting and audit fees, consulting fees and filing fees related to becoming a public reporting entity.

- Marketing, advertising and business development increased primarily related to radio and billboard advertising awareness campaigns.
- FDIC insurance assessments and Pennsylvania bank shares tax expense increased primarily due to incremental equity and deposits related to the merger with Affinity.
- Other real estate owned costs totaled \$118 thousand in the current quarter compared to none in 2012.
- Other expenses increased primarily related to incremental costs due to the addition of Affinity, including core deposit intangible amortization expense.

## Nine months ended September 30, 2013 compared to prior year

Salaries and employee benefits. The increase in the current year of \$1.08 million includes incremental staffing costs due to the addition of Affinity employees of approximately \$1.1 million. In addition, the company experienced a higher overall cost per employee of providing healthcare benefits and recorded a higher level of bonus accrual. The prior year included an accrual of \$255 thousand related to management's determination that the Company would meet the requirements of the 2009 Deferred Compensation Plan which was paid prior to the end of 2012.

Occupancy and equipment. The increase in the current year of \$690 thousand is primarily related to costs of incremental branch offices of Affinity.

Data processing equipment and operations. The increase in the current year of \$276 thousand includes approximately \$200 thousand of costs related to Affinity. In addition, the cost of outsourced core banking services processing related to a higher level of banking customer activity, which continues to increase.

*Professional fees.* Current year expenses increased by \$191 thousand. Of this increase, \$76 thousand relates to legal costs primarily to resolve loan workout situations, while accounting and audit fees increased \$48 thousand, consulting fees increased \$39 thousand and other professional fees which increased \$22 thousand.

*Marketing, advertising and business development.* These costs increased \$97 thousand in the current year primarily related to radio and billboard advertising campaigns designed to increase awareness of the Company's name in both the suburban Philadelphia market and in the Affinity Division's Berks market.

FDIC insurance assessments. This increase of \$67 thousand is primarily related to the addition of Affinity.

*Pennsylvania bank shares tax expense*. This tax is calculated based on the reported level of equity, adjusted for exclusions and other items, and therefore, increased \$107 thousand primarily due to incremental equity resulting from the merger with Affinity and the related private placement issuance.

Collateral protection expense. This expense totaled \$168 thousand for the nine months ended September 30, 2012. First Priority Bank entered into a settlement and release agreement in the second quarter of 2012; accordingly, collateral protection expense was eliminated beginning in the second half of 2012.

Other real estate owned costs. These costs, totaling \$280 thousand in 2013 compared to none in 2012, consist of valuation adjustments related to the fair value or sale of the properties held totaling \$127 thousand and \$192 thousand related to costs to acquire or maintain these properties during the holding period, net of rental income received of \$39 thousand. These properties were acquired either through deeds in lieu of foreclosure or through other means on properties that were used as collateral for bank loans.

*Other expenses*. Other expenses increased \$242 thousand for the nine months ended September 30, 2013. This increase is primarily related to incremental costs due to the addition of Affinity, including core deposit intangible amortization expense of \$62 thousand. In addition, expenses related to becoming a public reporting entity increased \$33 thousand.

# Merger related costs

First Priority Bank recorded \$1.53 million in merger related costs during the first nine months of 2013 for expenses paid or incurred related to the merger with Affinity compared to \$328 thousand for the first nine months of 2012. These expenses consisted largely of costs related to professional and consulting services, salary and employee benefits, consolidating a branch office, termination of Affinity's core system contractual agreement, conversion of systems and/or integration of operations, printing and filing costs of completing the transaction and investment banking charges, and initial communication expense to introduce First Priority to its new customers. These costs are outlined in the table below for each respective period.

		Months ded	Nine Me Ende		
	_Septen	ıber 30,	September 30,		
	2013	2012	2013	2012	
Accounting	<u>\$—</u>	\$ 62	\$ 26	\$ 67	
Branch consolidation	_	_	103	_	
Investment banking	_	_	350	_	
Investor & customer document printing and filing	35	14	153	14	
Legal	_	109	5	247	
Purchase accounting consulting	_	_	50	_	

Salaries and employee benefits	83	_	83	_
System contract termination	_	_	314	_
System conversion/deconversion costs	206		450	
	\$324	\$185	\$1,534	\$328

## Provision for Income Taxes

Management considers various factors in evaluating the need for a valuation allowance related to the Company's net deferred tax asset, including but not limited to forecasted future earnings which management believes provides positive evidence to support the utilization of the deferred tax asset in the future and the negative evidence of accumulated operating losses that First Priority experienced during the Company's start-up years. Management concluded that the weight of the positive evidence of future earnings was not sufficient to outweigh the negative evidence of prior period losses, and therefore, this analysis does not support the more likely than not requirement to reduce any portion of the valuation allowance for deferred tax assets at this time. Therefore, the Company has not recorded any income tax expense or benefit in the related statements of operations.

#### Balance Sheet Review

#### Overview

Total assets at September 30, 2013 were \$427.4 million, representing an increase of \$152.2 million or 55.3% when compared to total assets of \$275.1 million at December 31, 2012. Asset growth during this period is attributable primarily to the merger with Affinity. Total assets consisted principally of loans outstanding of \$332.2 million, investment securities of \$66.7 million and cash and cash equivalents of \$19.1 million at September 30, 2013 compared to loans outstanding of \$244.3 million, investments securities of \$16.7 million and cash and cash equivalents of \$11.0 million at December 31, 2012.

Loans outstanding increased \$87.9 million from year-end 2012 to September 30, 2013 or 36.0%. Loans acquired as of February 28, 2013 totaled \$77.4 million attributable to the merger with Affinity. Investment securities increased \$50.0 million during this period.

Deposits totaled \$340.8 million at September 30, 2013 compared to \$233.0 million at December 31, 2012, representing an increase of \$107.8 million or 46.3%. Deposit balances acquired through the merger totaling \$150.9 were partially offset by the planned maturities of brokered certificates of deposit totaling \$20.5 million and other deposit declines of \$22.6 million. Borrowings totaled \$37.9 million at September 30, 2013 compared to \$13 million at December 31, 2012, with growth primarily in short-term borrowings.

Equity capital at September 30, 2013 was \$42.2 million, compared to \$27.7 million at December 31, 2012. The enhanced capital position is attributable to net proceeds of \$6.6 million realized through the private placement of 1,268,576 shares of common stock offered in conjunction with the merger and \$10.0 million of common equity issued in the merger. These increases were partially offset by a net loss for the period of \$506 thousand, preferred dividends paid of \$359 thousand and volatility related to unrealized losses on investment securities of \$1.3 million.

#### Investments

First Priority's total investment portfolio was \$66.7 million at September 30, 2013, consisting of \$11.0 million of securities classified as held to maturity and \$55.7 million of available for sale securities compared to total investments of \$16.7 million at December 31, 2012, all of which were classified as available for sale. Total investments accounted for 15.6% and 6.1% of total assets at each respective date.

During the second quarter of 2013, the Company transferred \$11.2 million of obligations of states and political subdivisions from available for sale securities to be classified as held to maturity securities. Net unrealized holding gains arising prior to the reclassification date as of May 31, 2013, totaling \$292 thousand, are segregated within accumulated other comprehensive income. This balance will be amortized over the remaining life of the related securities as an adjustment of yield in a manner consistent with the accretion of discount on the same transferred debt securities. This will have no impact on the Company's net income because the amortization of the unrealized holding loss reported in equity will offset the effect on the interest income of the accretion of the discount on these securities. The remaining unamortized balance of holding gains on securities classified as held to maturity totaled \$267 thousand as of September 30, 2013. The transfer of securities from available for sale to held to maturity was completed in order to mitigate the volatility to common equity caused by sudden market fluctuations and to lock in a predictable earnings on these related securities.

Securities classified as available for sale are accounted for at fair value, with the difference between fair value and amortized cost reflected in the capital account as other comprehensive income or loss. Due to market fluctuations which occurred during the third quarter of 2013, the Company had net unrealized losses on available for sale securities totaling \$916 thousand at September 30, 2013, while total unrealized gains totaled \$683 thousand at December 31, 2012. Available for sale securities are securities that management intends to hold for an indefinite period of time or securities that may be sold in response to changes in interest rates, prepayment expectations, capital management and liquidity needs.

The total investment portfolio at September 30, 2013 was comprised of federal agency securities (36%), federal agency mortgage backed securities and agency collateralized mortgage obligations (33%), obligations of states and political subdivisions (29%, primarily federal taxable municipal securities), and corporate debt (2%). All investment securities were either government guaranteed, issued by a government agency or investment grade. First Priority had no investment securities deemed to have other than temporary impairment ("OTTI") at September 30, 2013 or December 31, 2012 and recorded no OTTI charges during the nine months ended September 30, 2013 or December 31, 2012.

The following table sets forth information about the contractual maturities and weighted average yields of investment securities at September 30, 2013. Actual maturities may differ from contractual maturities due to scheduled principal payments and unscheduled prepayments of mortgage backed securities and, where applicable, the ability of an issuer to call a security prior to the contractual maturity date.

					curities Availab As of September					
	Within 1 year		After one but within five years		After five but within ten years		Over ten years		Total	
	Amount	Yield	Amount	Yield	Amount (Dollars in thou	Yield isands)	Amount	Yield	Amount	Yield
U.S. Government agency securities	\$ —	_	\$ 12,344	1.28%	\$ 11,872	1.78%	\$ —	_	\$24,216	1.53%
Obligations of states and political subdivisions	_	_	511	1.20%	3,704	2.08%	3,736	3.63%	7,951	2.75%
Federal agency mortgage backed securities	_	_	_	_	2,771	1.56%	18,650	2.21%	21,421	2.13%
CMO's	_	_	_	_	448	1.81%	406	3.01%	854	2.38%
Other debt securities	252	0.61%	503	0.87%	_	_	467	4.37%	1,222	2.15%
Money market mutual fund	27	0.00%		_		_		_	27	0.00%
Total investments available for sale	\$ 279	0.55%	\$ 13,358	1.28%	\$ 18,795	1.80%	\$23,259	2.50%	\$55,691	1.96%

					As of Septemb					
	Within	1 voor	After one l		After five bu	ıt within	Over ten years Total			<u> </u>
	Amount	Yield	Amount	Yield	Amount (Dollars in th	Yield	Amount	Yield	Amount	Yield
Obligations of states and political subdivisions	\$ —	_	\$ —	_	\$ 1,594	2.86%	\$9,411	4.19%	\$11,005	4.00%
Total investments held to maturity	\$ —	_	\$ —	_	\$ 1,594	2.86%	\$9,411	4.19%	\$11,005	4.00%

The amortized cost and fair value of First Priority's investments, classified as available for sale or held to maturity, at September 30, 2013 and December 31, 2012 are shown in the following table:

		September 30, 2013			
	Amo	ortized Cost	Fair Value		
		(Dollars in thousands)			
Available For Sale:					
Obligations of U.S. government agencies and corporations	\$	24,612	\$24,216		
Obligations of states and political subdivisions		8,347	7,951		
Federal agency mortgage-backed securities		21,513	21,421		
Federal agency collateralized mortgage obligations		855	854		
Other debt securities		1,253	1,222		
Money market mutual fund		27	27		
Total investment securities available for sale	\$	56,607	\$55,691		
Held To Maturity:					
Obligations of states and political subdivisions	\$	11,005	\$10,428		
Total held to maturity	\$	11,005	\$10,428		

		December 31, 2012			
	Amo	ortized Cost	Fair Value		
		(Dollars in thousands)			
Available For Sale:					
Obligations of U.S. government agencies and corporations	\$	1,000	\$ 1,001		
Obligations of states and political subdivisions		11,304	11,857		
Agency mortgage-backed securities		3,552	3,681		
Money market mutual fund		140	140		
Total investment securities available for sale	\$	15,996	\$16,679		

#### Restricted investments in bank stocks

Restricted investments in bank stocks represent the investment in the common stock of correspondent banks required in order to transact business with those banks. Investments in restricted stock are carried at cost.

At September 30, 2013 and December 31, 2012, First Priority Bank held \$110 thousand and \$50 thousand, respectively, in common stock of Atlantic Central Bankers Bank, Camp Hill, Pennsylvania. The increase between the two dates is attributable to the merger with Affinity. Additionally, First Priority had investments in the common stock of the FHLB Bank of Pittsburgh totaling \$2.35 million and \$1.29 million as of September 30, 2013 and December 31, 2012, respectively. The increase in the investment is attributable to the incremental investment required to support increased borrowings.

#### Loans

First Priority's loan portfolio is the primary component of its assets. At September 30, 2013, total loans were \$332.2 million, representing an increase of \$87.9 million or 36.0% from total loans outstanding of \$244.3 million at December 31, 2012. Loans acquired as of February 28, 2013 totaled \$77.4 million attributable to the merger with Affinity.

The following table sets forth the classification of First Priority's loan portfolio at September 30, 2013 and December 31, 2012.

	Septemb	per 30, 2013	December 31, 2012			
	Amount	Percent of total	Amount	Percent of total		
Commercial & Industrial	\$ 79,038	24%	\$ 62,366	26%		
Commercial Mortgage	139,287	42%	93,775	38%		
Commercial Construction	3,671	1%	4,112	2%		
Total Commercial	221,996	67%	160,253	66%		
Residential Mortgage	56,780	17%	49,354	20%		
Home Equity Lines	31,286	9%	20,654	8%		
Other Consumer	22,464	7%	14,298	6%		
Total Consumer	53,750	16%	34,952	14%		
Total Loans	332,526	100%	244,559	100%		
Net deferred loan (fees) or costs	(329)		(284)			
Total	\$332,197	100%	\$244,275	100%		

A majority of First Priority Bank's loans are to business owners of many types. First Priority Bank makes commercial loans for real estate development and other business purposes required by its customer base.

First Priority Bank's credit policies determine advance rates against the different forms of collateral that can be pledged against commercial loans. Typically, the majority of loans will be limited to a percentage of their underlying collateral values such as real estate values, equipment, eligible accounts receivable and inventory. Individual loan advance rates may be higher or lower depending upon the financial strength of the borrower and/or term of the loan. The assets financed through commercial loans are used within the business for its ongoing operation. Repayment of these kinds of loans generally comes from the cash flow of the business or the ongoing conversions of assets. Commercial mortgage loans include loans to finance commercial real estate properties. Repayment of this kind of loan is dependent upon either the ongoing cash flow of the borrowing entity or the resale or lease of the subject property. Commercial mortgage loans typically require a loan to value ratio of not greater than 80% and vary in terms.

Residential mortgages and home equity loans are secured by the borrower's residential real estate in either a first or second lien position. Pricing for residential mortgages and home equity loans is subject to market conditions, the applicant's income and qualified credit bureau score and the collateral's loan to value ratio. Residential mortgages have amortization terms up to but not longer than 30 years and home equity loans generally have maturities up to 10 years.

Other consumer loans include installment loans, car loans, and overdraft lines of credit. The majority of these loans are secured.

Commercial mortgage loans consist of loans originated for commercial purposes which are secured by nonfarm nonresidential properties, multifamily residential properties, or 1-4 family residential properties. As of September 30, 2013 and December 31, 2012, commercial mortgage loans totaled \$139.3 million and \$93.8 million, respectively. In addition, as of September 30, 2013, loans to lessors of non-residential buildings totaled \$62.6 million which is included in commercial mortgage loans; of this amount, \$48.5 million, or 78% of these loans are related to owner occupied buildings.

The payment experience of certain non-owner occupied commercial mortgage loans may be dependent upon the successful operation of the real estate project. These risks can be significantly affected by supply and demand conditions in the market for office and retail space and for apartments and, as such, may be subject to a greater extent to adverse conditions in the economy. In dealing with these risk factors, First Priority generally limits itself to a real estate market or to borrowers with which First Priority has experience. First Priority generally concentrates on originating commercial real estate loans secured by properties located within its market area and many of First Priority's commercial real estate loans are secured by owner-occupied property with personal guarantees of the debt.

Regulatory guidance exists whereby total construction, land development and other land loans should not exceed 100% of total risk-based capital and further guidance whereby total construction, land development and other land loans combined with real estate loans secured by multifamily or nonresidential properties and loans to finance commercial real estate or construction loans (not secured by real estate) should not exceed 300% of total risk-based capital. First Priority Bank monitors these two ratios, which as of September 30, 2013, totaled 24% and 174% of total risk-based capital, respectively, both well within the regulatory suggested guidance.

#### Credit Quality

First Priority Bank's written lending policies require specified underwriting, loan documentation and credit analysis standards to be met prior to funding, with additional credit department approval for the majority of new loan balances. The Loan Committee is comprised of senior members of management who oversee the loan approval process to monitor that proper standards are maintained.

The accrual of interest on loans is generally discontinued when the contractual payment of principal or interest has become 90 days past due or when management has serious doubts about further collectability of principal or interest, even though the loan is currently performing. A loan may remain on accrual status if it is in the process of collection and is either guaranteed or well secured. When a loan is placed on non-accrual status, unpaid interest credited to income in the current year is reversed and unpaid interest accrued in prior years is charged against the allowance for loan losses. Interest received on non-accrual loans is generally either applied against principal or reported as interest income, according to management's judgment as to the collectability of principal. Generally, loans are restored to accrual status when the obligation is brought current, has performed in accordance with the contractual terms for a reasonable period of time, and the ultimate collectability of the total contractual principal and interest is no longer in doubt.

The following table summarizes non-performing assets and performing troubled debt restructurings which were in accruing status at the dates indicated.

	September 30, 2013	December 31, 2012
Loans past due 90 days or more and still accruing interest	\$ —	\$ —
Non-accrual loans	4,290	4,093
Total non-performing loans (1)	4,290	4,093
Other real estate owned	907	184
Repossessed assets (2)	75	
Total non-performing assets (3)	5,272	4,277
Performing troubled debt restructurings (4)	951	4,279
Total non-performing assets and performing troubled debt	ф. 6.222	Φ 0.556
restructurings	\$ 6,223	<u>\$ 8,556</u>
Non-performing loans as a percentage of total loans	1.29%	1.68%
Non-performing assets as a percentage of total assets	1.23%	1.55%
Non-performing assets and performing troubled debt restructurings		
as a percentage of total assets	1.46%	3.11%
Ratio of allowance to non-performing loans at end of period	52%	60%
Ratio of allowance to non-performing assets at end of period	42%	58%
Allowance for loan losses as a percentage of total loans	0.67%	1.01%
Allowance for loan losses as a percentage of originated loans (5)	0.80%	1.01%
Allowance for loan losses as a percentage of originated		
non-performing loans (5)	159%	60%

<sup>(1)</sup> Non-performing loans are comprised of (i) loans that have a non-accrual status; (ii) accruing loans that are 90 days or more past due and (iii) non-performing troubled debt restructured loans.

<sup>(2)</sup> Repossessed assets include personal property, consisting of manufactured housing, which has been acquired for debts previously contracted.

<sup>(3)</sup> Non-performing assets are comprised of non-performing loans, other real estate owned (assets acquired in foreclosure) and repossessed

<sup>(4)</sup> Performing troubled debt restructurings are accruing loans that have been restructured in troubled debt restructurings and are in compliance with their modified terms.

<sup>(5)</sup> The allowance for loan losses as a percentage of originated loans excludes loans acquired in the merger with Affinity, which were recorded at acquisition date at their fair values, including a discount related to potential credit impairment for the acquired loans. Therefore, the acquired loans are excluded from the calculation of loan loss reserves as of the acquisition date. The carryover of an allowance for loan losses is prohibited as any credit losses in the loans are included in the determination of the fair value.

Total non-performing loans were \$4.3 million at September 30, 2013, an increase of \$197 thousand from the \$4.1 million at December 31, 2012. This slight increase consisted of the addition of acquired non accrual loans totaling \$2.4 million from the merger with Affinity plus seven new loans moved to non-accrual status during the first nine months of 2013 totaling \$1.6 million. These increases were partially offset by the liquidation of two properties totaling \$2.3 million resulting in substantially no gain or loss. In addition, one loan totaling \$0.4 million was upgraded to performing status, three loans totaling \$0.5 million were transferred to other real estate owned, and three loans were partially charged-off in the amount of \$0.6 million. Non-performing loans as a percentage of total loans at September 30, 2013 was 1.29%, down from 1.68% at December 31, 2012. Other real estate owned totaled \$907 thousand at September 30, 2013 and \$184 thousand at December 31, 2012, an increase of \$723 thousand. Repossessed assets totaled \$75 thousand at September 30, 2013. There were no repossessed assets at December 31, 2012. Non-performing assets totaled \$5.3 million, or 1.23% of total assets, as of September 30, 2013, compared to \$4.3 million, or 1.55% of total assets as of December 31, 2012.

While not considered non-performing, First Priority's performing troubled debt restructurings are closely monitored as they consist of loans that have been modified where the borrower is experiencing financial difficulty. Troubled debt restructurings may be deemed to have a higher risk of loss than loans which have not been restructured. At September 30, 2013 and December 31, 2012, First Priority's performing troubled debt restructurings totaled \$951 thousand, consisting of two commercial loan relationships, one of which was acquired through the merger with Affinity, totaling \$190 thousand, and one commercial relationship totaling \$761 thousand, which are paid current.

First Priority Bank's management continues to monitor and explore potential options and remedial actions to recover First Priority Bank's investment in non-performing loans. According to policy, First Priority Bank is required to maintain a specific reserve for impaired loans. See the "Allowance for Loan Losses" section below for further information.

First Priority Bank's total delinquency amount is comprised of loans past due 30 to 89 days and still accruing plus the balance of non-performing loans. As of September 30, 2013 and December 31, 2012, loans past due 30 to 89 days and still accruing totaled \$442 thousand and \$674 thousand, respectively, which when added to the non-performing loans for each period, resulted in a total delinquency ratio of 1.42% and 1.95%, respectively, of total loans outstanding.

## Allowance for Loan Losses

The allowance for loan losses represents an amount that First Priority believes will be adequate to absorb estimated credit losses on loans that may become impaired. While First Priority applies the methodology discussed below in connection with the establishment of the allowance for loan losses, the allowance is subject to critical judgments on the part of management. Risks within the loan portfolio are analyzed on a continuous basis by the management of First Priority Bank, periodically analyzed by an external independent loan review function, and are also reviewed by the audit committee. A risk system, consisting of multiple grading categories, is utilized as an analytical tool to assess risk and appropriate allowances. In addition to the risk system, management further evaluates the risk characteristics of the loan portfolio under current and anticipated economic conditions and considers such factors as the financial condition of the borrower, past and expected loss experience, and other factors which management believes deserve recognition in establishing an appropriate allowance. These estimates are reviewed at least quarterly, and, as adjustments become necessary, they are realized in the periods in which they become known.

First Priority uses a quantitative and qualitative method to allocating its allowance to the various loan categories. An unallocated component, which is maintained to cover uncertainties that could affect management's estimate of probable losses, reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

Additions to the allowance are made by provisions charged to expense, and the allowance is reduced by net charge-offs, which are loans judged to be uncollectible, less any recoveries on loans previously charged off. Although management attempts to maintain the allowance at an adequate level, future additions to the allowance may be required due to the growth of the loan portfolio, changes in asset quality, changes in market conditions and other factors. Additionally, various regulatory agencies periodically review the allowance for loan losses. These agencies may require additional provisions based upon their judgment about information available to them at the time of their examination. Although management uses what it believes to be the best information available, the level of the allowance for loan losses remains an estimate which is subject to significant judgment and short term change.

Acquired loans are initially recorded at acquisition date at their acquisition date fair values, and therefore, are excluded from the calculation of loan loss reserves as of the acquisition date. To the extent there is a decrease in the present value of cash flows from the acquired impaired loans after the date of acquisition, the Company records a provision for potential losses. During the three and nine months ended September 30, 2013, the Company recorded a provision for loan losses totaling \$89 thousand for acquired impaired loans. There were no acquired loans as of December 31, 2012.

For acquired loans that are not deemed impaired at acquisition, credit discounts representing the principal losses expected over the life of the loan are a component of the initial fair value. Subsequent to the acquisition date, the methods utilized to estimate the required allowance for loan losses for these loans is similar to originated loans, however, the Company records a provision for loan losses only when the required allowance exceeds any remaining pooled discounts for loans evaluated collectively for impairment. During the nine months ended September 30, 2013, the Company recorded a provision for loan losses totaling \$118 thousand on acquired non-impaired loans. There were no acquired loans as of December 31, 2012.

The Bank's policy for interest income recognition on nonaccrual loans is to recognize income under the cash basis when the loans are both current and the collateral on the loan is sufficient to cover the outstanding obligation to the Bank. The Bank will not recognize income if these factors do not exist. Interest that would have been accrued on non-accruing loans under the original terms but was not recognized as interest income totaled \$91 thousand and \$216 thousand for the three and nine months ended September 30, 2013 and \$32 thousand and \$145 thousand for the three and nine months ended September 30, 2012, respectively.

Based on the information available as of September 30, 2013, management believes that the allowance for loan losses of \$2.2 million is adequate as of that date.

The following table sets forth a summary of the changes in the allowance for loan losses for the periods indicated:

	For the thi		For the nine months ended September 30,		
	2013	2012	2013	2012	
	(Dollars in	thousands)	(Dollars in t	housands)	
Balance at the beginning of period	\$ 2,229	\$ 2,427	\$ 2,460	\$ 2,470	
Charge-offs:					
Commercial and Industrial	_	7	339	207	
Commercial Mortgage	137	_	137	_	
Commercial Construction	_	_	_	_	
Residential Mortgage Loans	6		14	_	
Home equity lines of credit	86	_	332	190	
Other consumer loans	9	_	9	_	
Total loans charged off	238	7	831	397	
Recoveries:					
Commercial and Industrial	11	1	19	2	
Commercial Mortgage	_	_	_	_	
Commercial Construction	_	_	_	_	
Residential Mortgage Loans	_	_	7	_	
Home equity lines of credit	_	_	_	_	
Other consumer	4	1	11	17	
Total recoveries	15	<u>2</u> 5	37	19	
Net loans charged off	223	5	794	378	
Provision charged to operations	230	80	570	410	
Balance at end of period	\$ 2,236	\$ 2,502	\$ 2,236	\$ 2,502	
Average loans (1)	\$329,982	\$242,654	\$312,453	\$241,850	
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Ratio of net charge-offs during period to average loans outstanding during period (annualized) (1)	0.27%	0.01%	0.34%	0.21%	
Allowance for loan losses as a percentage of total loans	0.67%	1.03%	0.67%	1.03%	
Allowance for loan losses as a percentage of non-acquired loans	0.80%	1.03%	0.80%	1.03%	

<sup>(1)</sup> Includes non-accrual loans

The allowance for loan losses was \$2.2 million at September 30, 2013 and \$2.5 million at December 31, 2012, which represented 0.67% and 1.01% of total loans outstanding at each respective date. The allowance as a percentage of originated loans as of September 30, 2013 was 0.80%. The allowance for loan losses as a percentage of originated loans excludes loans acquired in the merger with Affinity, which were recorded at acquisition date at their fair values, including a discount related to potential credit impairment for the acquired loans. Therefore, acquired loans are excluded from the calculation of the loan loss reserve as of the acquisition date. The carryover of an allowance for loan losses is prohibited as any credit losses in the loans are included in the determination of the fair value. As discussed in Note 2 – "Merger with Affinity Bancorp, Inc.," as of February 28, 2013, acquired loans without evidence of credit deterioration included a general credit fair value adjustment of \$1.6 million while acquired credit impaired loans included a nonaccretable discount of \$1.6 million representing a specific credit valuation adjustment. As of September 30, 2013, the unamortized portion of the general credit fair value adjustment totaled \$1.1 million and the total specific credit market valuation adjustment totaled \$1.5 million, inclusive of \$120 thousand of accretable discount. Additionally, the combination of these remaining credit fair value adjustments related to acquired loans, totaling \$2.6 million, and the allowance for loan losses of \$2.2 million, or a total of \$4.8 million, would equate to 1.44% of total loans outstanding as of September 30, 2013. There were no acquired loans as of December 31, 2012. Net charge-offs for the Company totaled \$794 thousand for the first nine months of 2013 compared to \$378 thousand for the same period in 2012.

The following table sets forth the allocation of the allowance for loan losses by loan category. The specific allocations in any particular category may be reallocated in the future to reflect the then current conditions. Accordingly, management considers the entire allowance to be available to absorb losses in any category.

	(In thousands except percentage data)				
	September 30, 2013 D			December 31, 2012	
	Percent of total loans			Percent of total loans	
	Amount	(1)			
Commercial and Industrial	\$ 393	3 24%	\$ 566	26%	
Commercial Mortgage	454	4 42%	559	38%	
Commercial Construction	8	8 1%	31	2%	
Residential Mortgage Loans	148	8 17%	176	20%	
Home Equity Lines of Credit	170	5 9%	89	8%	
Other Consumer Loans	76	<u>7</u> %	41	<u>6</u> %	
Total Allocated	1,255	5 100%	1,462	100%	
Unallocated	983	<u> </u>	998		
TOTAL	\$ 2,230	<u>6</u>	\$ 2,460		

<sup>(1)</sup> Represents loans outstanding in each category, as of the date shown, as a percentage of total loans outstanding

A specific allocation of the allowance for loan losses of \$89 thousand has been provided on originated impaired loans of \$1.4 million at September 30, 2013 compared to a specific allocation of \$616 thousand related to \$10.7 million of impaired loans at December 31, 2012. The decrease in the level of the specific allocation for loan losses is partially due to an improvement in the financial conditions of four borrowers with previous outstanding balances of \$6.2 million with specific allocations totaling \$259 thousand which were refinanced or upgraded. Additionally two properties with loan balances of \$2.3 million and specific reserves of \$151 thousand were liquidated with substantially no gain or loss while one loan with a specific reserve of \$100 thousand was charged off.

The September 30, 2013 qualitative and quantitative analysis of the loan portfolio, after the effect of net charge-offs and the above mentioned specific allocation, resulted in the general portion of the allowance for loan losses of \$1.2 million compared to \$846 thousand at December 31, 2012.

#### Loan Concentrations

The Bank's loans consist of credits to borrowers spread over a broad range of industrial classifications. The largest concentrations of loans are to lessors of nonresidential buildings and lessors of residential buildings and dwellings. As of September 30, 2013, these loans totaled \$62.6 million and \$42.3 million, respectively, or 18.8% and 12.7%, respectively, of the total loans outstanding. As of December 31, 2012, these same classifications of loans totaled \$48.1 million and \$27.6 million, respectively, or 19.7% and 11.3%, respectively, of the total loans outstanding at that time. These credits were subject to normal underwriting standards and did not present more than the normal amount of risk assumed by the Bank's other lending activities. Management believes this concentration does not pose abnormal risk when compared to the risk it assumes in other types of lending. The Bank has no other concentration of loans which exceeds 10% of total loans.

## Deposits

Deposits represent the primary source of funding for earning assets. Deposits totaled \$340.8 million at September 30, 2013 compared to \$233.0 million at December 31, 2012, representing an increase of \$107.8 million or 46.3%. Deposits acquired through the merger totaling \$150.9 were partially offset by the planned maturities of brokered certificates of deposit totaling \$20.5 million and other deposit declines of \$22.6 million.

It has been a strategic objective of First Priority to develop its core deposit base and to supplement core deposits with cost effective alternative funding sources. The merger with Affinity provided the opportunity to expand core deposits and enhance the mix of deposit sources. For the period ended September 30, 2013 compared to December 31, 2012, First Priority recorded increases in transaction account balances of \$44.0 million, or 117.3%, with non-interest bearing transaction accounts increasing \$9.9 million and interest bearing transaction accounts increasing \$34.1 million of the total growth. Also during this period money market and savings accounts increased \$48.4 million, or 81.2%, for a net increase in these key core deposit categories of \$92.4 million, or 95.2%.

First Priority attracts deposits by offering competitive products and interest rates on a broad spectrum of deposit products to customers in its local marketplace, generally through its retail branch system, and also through its internet banking platform. First Priority Bank supplements deposits raised locally with the issuance of brokered deposits when cost effective relative to local market pricing. At September 30, 2013 and December 31, 2012, brokered deposits totaled \$27.9 million and \$48.5 million, respectively. The guidelines governing First Priority Bank's participation in the brokered CD market are included in First Priority Bank's Asset Liability Management Policy, which is reviewed, revised and approved annually by the asset liability management committee and the board of directors. The FDIC places restrictions on a depository institution's use of brokered deposits based on the bank's capital classification. A well-capitalized institution may accept brokered deposits without FDIC restrictions. An adequately capitalized institution must obtain a waiver from the FDIC in order to accept brokered deposits, while an undercapitalized institution is prohibited by the FDIC from accepting brokered deposits. First Priority Bank is classified as well-capitalized under prompt corrective action provisions (see Note 11—"Regulatory Matters" of the Unaudited Notes to Consolidated Financial Statements) and, therefore, may accept brokered deposits without FDIC restrictions.

The following table sets forth the average balance of First Priority's deposits and the average rates paid on deposits for the periods presented.

	For the three months ended September 30,			For the nine months ended September 30,				
	2013 2012			2013		2012		
	Average		Average		Average		Average	
	Balance	Rate	Balance	Rate	Balance	Rate	Balance	Rate
	(Dollars in thousands)			(Dollars in thousands)				
Demand, non-interest bearing	\$ 37,580		\$ 27,097		\$ 35,401		\$ 25,863	
Demand, interest-bearing	45,623	0.27%	9,019	0.33%	38,504	0.27%	6,542	0.29%
Money market and savings deposits	108,679	0.37%	54,196	0.63%	96,512	0.40%	54,257	0.65%
Time deposits	152,537	1.60%	142,697	1.95%	154,209	1.64%	152,015	2.00%
Total interest-bearing deposits	306,839	0.96%	205,912	1.53%	289,225	1.05%	212,814	1.60%
Total deposits	\$344,419		\$233,009		\$324,626		\$238,677	

The maturity distribution of time deposits of \$100,000 or more as of September 30, 2013, is as follows:

	September 30, 2013
	(Dollars in thousands)
Three Months or Less	\$ 4,405
Over Three Through Six Months	3,346
Over Six Through Twelve Months	9,613
Over Twelve Months	28,535
TOTAL	\$ 45,899

Other Interest-Bearing Liabilities Short-Term Borrowed Funds

At September 30, 2013, First Priority had short-term borrowings totaling \$26.9 million, consisting of overnight or less than 30 day advances from the FHLB. There were no short-term borrowings at December 31, 2012. Advances from the FHLB at September 30, 2013 are collateralized by our investment in the common stock of the FHLB and by a blanket lien on selected mortgage loans within First Priority Bank's loan portfolio.

The following table outlines First Priority's various sources of short-term borrowed funds at or for each of the nine months ended September 30, 2013 and 2012. The maximum balance represents the highest indebtedness for each category of short-term borrowed funds at any month end during each of the periods shown.

	At or for the Nine Months Ended September 30,				
		2013 2012			
		(Dollars in thousands)			
Federal funds purchased:					
Balance at period end	\$	_	\$	_	
Weighted average rate at period end		_		_	
Maximum month-end balance	\$	492	\$	_	
Average daily balance during the period	\$	30	\$	19	
Weighted average rate during the period		0.51%		0.58%	
Other short-term borrowings:					
Balance at period end	\$	26,875	\$	8,530	
Weighted average rate at period end		0.24%		0.25%	
Maximum month-end balance	\$	26,875	\$	8,900	
Average daily balance during the period	\$	5,793	\$	3,233	
Weighted average rate during the period		0.24%		0.26%	

## Long-Term Debt

Long-term debt totaled \$11.0 million and \$13.0 million at September 30, 2013 and December 31, 2012, respectively. These borrowings consisted of advances from the FHLB with an average interest rate of 0.88% and 1.37% at each of these dates, respectively, and an average remaining life of 3.5 years and 3.6 years, respectively. Advances from the FHLB are collateralized by an investment in the common stock of the FHLB, by a specific pledge of First Priority Bank's investment assets and by a blanket lien on selected mortgages within First Priority Bank's loan portfolio. Balances of FHLB long-term debt averaged \$12.7 million for the nine months ending September 30, 2013 and \$6.6 million during the same period in 2012 with an average rate of 1.26% for the first nine months of 2013 and 3.65% for the same period in 2012. The maximum month-end balance of these borrowings was \$26.0 million and \$13.0 million for the first nine months of 2013 and 2012, respectively.

## Capital Resources

Under TARP, the Treasury authorized a voluntary Capital Purchase Program to purchase up to \$250 billion of senior preferred shares of qualifying financial institutions. This program was created to stabilize the financial system by directly infusing capital into healthy, viable institutions, thereby increasing their capacity to lend to U.S. businesses and consumers and support the U.S. economy. On February 20, 2009, First Priority issued to the Treasury 4,579 shares of First Priority's Series A preferred stock and a warrant to purchase, on a net basis, 229 shares of First Priority's Series B preferred stock, which was immediately exercised, for an aggregate purchase price of \$4.6 million under the TARP CPP.

On May 21, 2009, the Treasury announced an expansion of the TARP CPP for small community banks to help stimulate lending to

small to medium size businesses. On December 18, 2009, First Priority entered into an additional purchase agreement with the Treasury as part of the Treasury's TARP CPP for Small Banks, pursuant to which First Priority issued and sold, and the Treasury agreed to purchase 4,596 shares of Series C preferred stock, \$100.00 par value per share, having a liquidation preference of \$1,000 per share, for an aggregate purchase price of \$4.6 million (see Note 8 of the Unaudited Notes to Consolidated Financial Statements).

On February 8, 2013, the U.S. Department of Treasury sold its entire holdings of the Company's preferred stock as part of its ongoing efforts to wind down and recover its remaining Capital Purchase Program ("CPP") investments in financial institutions through a modified Dutch auction methodology by offering to domestic qualified institutional buyers and certain domestic institutional accredited investors an opportunity to purchase the Company's preferred stock from the Treasury. Upon final closing of the sale of these securities to private investors, the previously placed limitations on executive compensation expired. There were no additional changes to the previously existing outstanding preferred stock which resulted from the sale to private investors.

Shareholders' equity totaled \$42.2 million and \$27.7 million at September 30, 2013 and December 31, 2012, respectively. The increase in shareholders' equity of \$14.5 million during the first nine months of 2013 resulted primarily from the issuance of \$6.6 million of common equity through the private placement; incremental capital related to the acquisition of Affinity totaling \$10.0 million; partially offset by a net loss for the period of \$506 thousand, preferred dividends paid of \$359 thousand and volatility related to unrealized losses on investment securities of \$1.3 million.

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

Under the capital adequacy guidelines, established by regulatory agencies, capital is classified into two tiers. These guidelines require an institution to maintain a certain level of Tier 1 and Tier 2 capital to risk-weighted assets. Tier 1 capital consists of common shareholders' equity and qualifying preferred stock, excluding the unrealized gain or loss on securities available for sale, minus certain intangible assets plus trust preferred securities up to 25% of Tier 1 capital, with the excess being treated as Tier 2 capital. Tier 2 capital also consists of the allowance for loan losses, subject to certain limitations, and qualifying subordinated debt. In determining the amount of risk-weighted assets, all assets, including certain off-balance sheet assets, are multiplied by a risk-weight factor of 0% to 100% based on the risks believed inherent in the type of asset.

Quantitative measures established by regulation to ensure capital adequacy require First Priority Bank to maintain minimum amounts and ratios of total and Tier 1 capital (as defined in the regulations) to risk-weighted assets and of Tier 1 capital to average assets, known as the Tier 1 leverage ratio. Under the capital guidelines, First Priority Bank must maintain a minimum total risk-based capital of 8%, with at least 4% being Tier 1 capital. In addition, First Priority Bank must maintain a minimum Tier 1 leverage ratio of at least 4%. To be considered "well-capitalized," First Priority Bank must maintain total risk-based capital of at least 10%, Tier 1 capital of at least 6%, and a leverage ratio of at least 5%.

The following table sets forth First Priority Bank's capital ratios at September 30, 2013 and December 31, 2012. For both periods, First Priority Bank was considered "well-capitalized" and met or exceeded its applicable regulatory requirements.

	To Be Considered "Well-Capitalized"	As of September 30, 2013	As of December 31, 2012
First Priority Bank:			
Total risk-based capital	10.00%	12.96%	12.48%
Tier 1 risk-based capital	6.00%	12.25%	11.39%
Tier 1 leverage capital	5.00%	9.54%	9.40%

First Priority Bank's total risk based capital ratio and its Tier 1 ratio improved during the period from December 31, 2012 to September 30, 2013 due primarily to the impact of the merger with Affinity and the issuance of \$6.6 million in equity capital through the private placement offering.

In June 2012, the federal bank regulatory agencies issued a series of proposed revisions to the agencies' capital adequacy guidelines and prompt corrective action rules, which were designed to enhance such requirements and implement the revised standards of the Basel Committee on Banking Supervision, commonly referred to as Basel III. In July 2013, the federal bank regulatory agencies adopted final rules, which differ in certain respects from the June 2012 proposals.

The July 2013 final rules generally implement higher minimum capital requirements, add a new common equity tier 1 capital requirement, and establish criteria that instruments must meet to be considered common equity tier 1 capital, additional tier 1 capital or tier 2 capital. The new minimum capital to risk-adjusted assets requirements are a common equity tier 1 capital ratio of 4.5% (6.5% to be considered "well capitalized") and a tier 1 capital ratio of 6.0%, increased from 4.0% (and increased from 6.0% to 8.0% to be considered "well capitalized"); the total capital ratio remains at 8.0% under the new rules (10.0% to be considered "well capitalized"). Under the new rules, in order to avoid limitations on capital distributions (including dividend payments and certain discretionary bonus payments to executive officers), a banking organization must hold a capital conservation buffer comprised of common equity tier 1 capital above its minimum risk-based capital requirements in an amount greater than 2.5% of total risk-weighted assets. The new minimum capital requirements are effective on January 1, 2015. The capital contribution buffer requirements phase in over a three-year period beginning January 1, 2016.

The July 2013 final rules include three significant changes from the June 2012 proposals: (i) the final rules do not change the current risk weighting for residential mortgage exposures; (ii) the final rules permit institutions, other than certain large institutions, to elect to continue to treat certain components of accumulated other comprehensive income as permitted under the current general risk-based capital rules, and not reflect unrealized gains and losses on available-for-sale securities in common equity tier 1 calculations; and (iii) the final rules permit institutions with less than \$15.0 billion in assets to grandfather certain non-qualifying capital instruments (including trust preferred securities) issued prior to May 19, 2009 into tier 1 capital.

The Company and the Bank will continue to analyze these new rules and their effects on the business, operations and capital levels of the Company and the Bank.

# Return on Average Equity and Assets

The following table shows the return on average assets (net income to common shareholders divided by total average assets), return on equity (net income to common shareholders divided by average equity), and the equity to assets ratio (average equity divided by total average assets) for the nine months ended September 30, 2013 and 2012.

	At or for the nine months en	At or for the nine months ended September 30,		
	2013	2012		
Return on average assets	-0.18%	0.27%		
Return on average equity	-1.65%	2.65%		
Average equity to average assets ratio	10.65%	10.02%		

## Effect of Inflation and Changing Prices

The effect of relative purchasing power over time due to inflation has not been taken into effect in First Priority's consolidated financial statements. Rather, the statements have been prepared on a historical cost basis in accordance with accounting principles generally accepted in the United States of America.

Unlike most industrial companies, the assets and liabilities of financial institutions, such as First Priority and First Priority Bank, are primarily monetary in nature. Therefore, the effect of changes in interest rates will have a more significant impact on its performance than will the effect of changing prices and inflation in general. In addition, interest rates may generally increase as the rate of inflation increases, although not necessarily in the same magnitude. First Priority seeks to manage the relationships between interest-sensitive assets and liabilities in order to protect against wide interest rate fluctuations, including those resulting from inflation.

## **Off-Balance Sheet Arrangements**

Through the operations of First Priority Bank, First Priority has made contractual commitments to extend credit, in the ordinary course of its business activities, to meet the financing needs of customers. Such commitments involve, to varying degrees, elements of credit risk and interest rate risk in excess of the amount recognized on the balance sheets. These commitments are legally binding agreements to lend money at predetermined interest rates for a specified period of time and generally have fixed expiration dates or other termination clauses. The same credit and collateral policies are used in making these commitments as for on-balance sheet instruments.

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. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. Each customer's creditworthiness is evaluated on a case-by-case basis and collateral is obtained, if necessary, based on the credit evaluation of the borrower. The amount of collateral obtained, if deemed necessary by First Priority Bank upon extension of credit, is based on management's credit evaluation. Collateral held varies but may include personal or commercial real estate accounts receivable, inventory and equipment.

At September 30, 2013 and December 31, 2012, outstanding commitments to extend credit consisting of total unfunded commitments under lines of credit were \$74.4 million and \$53.7 million, respectively. In addition, as of each of these dates, there were \$1.3 million of performance standby letters of credit outstanding, and as of September 30, 2013, \$1.3 million of financial standby letters of credit. There were no financial standby letters of credit outstanding as of December 31, 2012. First Priority believes that it has adequate sources of liquidity to fund commitments that may be drawn upon by borrowers.

In addition, as of September 30, 2013 and December 31, 2012 the Bank pledged \$199 thousand of deposit balances at a correspondent bank to support a \$199 thousand letter of credit issued by the correspondent on behalf of a customer of the Bank. This transaction is fully secured by the customer through a pledge of the customer's deposits at the Bank. Also, as of September 30, 2013, the Bank had outstanding a financial standby letter of credit, which was collateralized by a pledge of Bank assets at a correspondent bank totaling

# \$512 thousand.

First Priority is not involved in any other off-balance sheet contractual relationships, unconsolidated related entities that have off-balance sheet arrangements or transactions that could result in liquidity needs or other commitments that could significantly impact earnings.

## Liquidity

The objective of liquidity management is to assure that sufficient sources of funds are available, as needed and at a reasonable cost, to meet the ongoing and unexpected operational cash needs and commitments of First Priority and to take advantage of income producing opportunities as they arise. Sufficient liquidity must be available to meet the cash requirements of depositors wanting to withdraw funds and of borrowers wanting their credit needs met. Additionally, liquidity is needed to insure that First Priority has the ability to act at those times when profitable new lending and investment opportunities arise. While the desired level of liquidity may vary depending upon a variety of factors, it is a primary goal of First Priority to maintain adequate liquidity in all economic environments through active balance sheet management.

Liquidity management is the ongoing process of monitoring and managing First Priority's sources and uses of funds. The primary sources of funds are deposits, scheduled amortization of loans outstanding, maturities and cash flow generated from the investment portfolio and funds provided by operations. Scheduled loan payments and investment maturities are relatively predictable sources of funds; however, deposit flows and loan prepayments are far less predictable and are influenced by the level of interest rates, economic conditions, local competition and customer preferences. Liquidity is also provided by unused lines of credit with correspondent banks and First Priority's borrowing capacity at the FHLB. First Priority measures and monitors its liquidity position on an ongoing basis in order to better understand, predict and respond to balance sheet trends, unused borrowing capacity and liquidity needs. The liquidity position is managed on a daily basis as part of the daily settlement function and on an ongoing basis through the asset liability management function.

The key elements of First Priority's liquidity planning process involve a primary focus on the development of a stable, core funding base; utilization of wholesale funding sources to supplement core funding; maintenance of an appropriate level of asset liquidity; management of the maturity structure of funding sources and of funding concentrations; and maintenance of borrowing facilities.

Wholesale funding sources utilized by First Priority Bank include brokered certificates of deposits, secured advances from the Federal Home Loan Bank of Pittsburgh, federal funds purchased and other secured borrowing facilities. At September 30, 2013, wholesale funding sources totaled \$65.8 million and were comprised of \$27.9 million of brokered certificates of deposit and \$37.9 million of FHLB advances. At December 31, 2012, wholesale funding sources totaled \$61.5 million and were comprised of \$48.5 million of brokered certificates of deposit and \$13.0 million of secured funding from the FHLB. Wholesale funding is generally used in managing the daily liquidity needs and when it is the most cost effective funding source available to First Priority. Management continually evaluates all available funding sources for cost and availability.

An integral part of First Priority Bank's balance sheet management strategy is to establish and maintain borrowing facilities with correspondent banks, for access to funding. Off balance sheet borrowing capacity provides the immediate availability of funds to meet short term financing needs without requiring the bank to maintain excess liquidity in its investment portfolio, which may have a negative impact on earnings. In today's environment of historically low interest rates, it also provides the most effective longer term funding, in terms of the cost and structure. Long term borrowings from the FHLB cannot be called prior to maturity, which provides much greater protection against a rise in interest rates when compared to retail deposits which can be redeemed early by the depositor at lower than market rate penalties.

As of September 30, 2013 and December 31, 2012, First Priority Bank had a borrowing facility with a correspondent bank totaling \$10 million, available for short-term limited purpose usage, of which \$2 million is available unsecured. The remaining \$8 million is a secured line of credit.

At September 30, 2013 and December 31, 2012, First Priority Bank had a total borrowing capacity with the FHLB of \$99.3 million and \$85 million, respectively, with advances outstanding against this capacity of \$37.9 million and \$13.0 million, respectively.

Short-term liquid assets held in interest-bearing deposit accounts with correspondent banks totaled \$13.4 million at September 30, 2013 compared to \$6.2 million at December 31, 2012. The balance at September 30, 2013 was comprised primarily of deposits held at the Federal Reserve Bank in First Priority Bank's excess balance account.

### **Interest Rate Sensitivity**

It is the responsibility of the board of directors and senior management to understand and control the interest rate risk exposures assumed by First Priority. The board has delegated authority to the asset liability management committee ("ALCO") for the development of ALCO policies and for the management of the asset liability management function. The ALCO committee is comprised of senior management representing all primary functions of First Priority and meets monthly. ALCO has the responsibility for maintaining a level of interest rate risk exposures within board of director approved limits.

The primary objective of asset liability management is to optimize net interest income over time while maintaining a balance sheet mix that is prudent with respect to liquidity, capital adequacy and interest rate risk. The absolute level and volatility of interest rates can have a significant impact on the profitability of First Priority. Interest rate risk management is the process of identifying and controlling the potential adverse impact of interest rates movements on First Priority's net interest income and on the fair value of its assets and liabilities.

One tool used to monitor interest rate risk is the measurement of its interest sensitivity "gap," which is the positive or negative dollar difference between interest-earning assets and interest-bearing liabilities that are subject to interest rate repricing within a given period of time. Interest rate sensitivity can be managed by changing the mix, pricing and repricing characteristics of its assets and liabilities, through management of its investment portfolio, loan and deposit product offerings, and through wholesale funding. Managing the amount of assets and liabilities repricing in the same time interval helps to hedge interest rate risk and minimize the impact on net interest income of rising or falling interest rates. First Priority generally would benefit from increasing market rates of interest when it has an asset-sensitive gap position and generally would benefit from decreasing market rates of interest when First Priority is liability-sensitive.

At September 30, 2013, First Priority was moderately liability sensitive at the one-year gap position, as it has more liabilities subject to repricing in the subsequent twelve month period than assets. It must be noted, however, that the gap analysis is not a precise indicator of First Priority's exposure to changing interest rates. The analysis presents only a static view of the timing of maturities and repricing opportunities, without taking into consideration that changes in interest rates do not affect all assets and liabilities equally. Furthermore, the results are influenced by management assumptions concerning the repricing characteristics of deposit products with no contractual maturities, the timing of the repricing of variable rate loans with interest rates currently fixed at interest rate floors, and prepayment speeds of loans and investments subject to prepayment prior to maturity. Additionally, net interest income performance may be impacted by other significant factors in a given interest rate environment, including changes in the volume and mix of interest-earning assets and interest bearing liabilities.

#### **Contractual Obligations**

First Priority Bank utilizes a variety of deposit products and short-term borrowings to supplement its supply of lendable funds, to assist in meeting deposit withdrawal requirements, and to fund growth of interest-earning assets in excess of traditional deposit growth. Brokered certificates of deposit, borrowings from the FHLB, borrowings under correspondent bank lines of credit, and repurchase agreements serve as the primary sources of such funds.

Obligations under non-cancelable operating lease agreements are payable over several years with the longest obligation expiring in 2029. Management does not believe that any existing non-cancelable operating lease agreements are likely to materially impact First Priority's financial condition or results of operations in an adverse way.

The following table provides payments due by period for contractual obligations as of September 30, 2013.

	Payments Due by Period					
		Over 1	Over 2	Over 3		
	Within 1	through 2	through 3	through 5	Over 5	
	Year	Years	Years	Years	Years	Total
			(In the	ousands)		
Certificates of deposit	\$59,894	\$40,167	\$23,803	\$16,544	\$10,911	\$151,319
Operating lease obligations	1,263	1,163	1,013	1,551	4,350	9,340
Long-term debt	_	1,000	3,000	7,000	_	11,000
Short-term borrowings	26,875		_	_		26,875
Accrued interest payable	372	_	_	_		372
Total	\$88,404	\$42,330	\$27,816	\$25,095	\$15,261	\$198,906

#### Item 3. Quantitative and Qualitative Disclosures about Market Risk

Risk identification and management are essential elements for the successful management of First Priority. In the normal course of business, First Priority is subject to various types of risk, including interest rate, credit, and liquidity risk. First Priority controls and monitors these risks with policies, procedures, and various levels of managerial and board oversight. First Priority's objective is to optimize profitability while managing and controlling risk within board approved policy limits. Interest rate risk is the sensitivity of net interest income and the market value of financial instruments to the magnitude, direction, and frequency of changes in interest rates. Interest rate risk results from various repricing frequencies and the maturity structure of assets and liabilities. First Priority uses its asset liability management policy to control and manage interest rate risk.

Liquidity risk represents the inability to generate cash or otherwise obtain funds at reasonable rates to satisfy commitments to borrowers, as well as, the obligations to depositors and debt holders. First Priority uses its asset liability management policy and contingency funding plan to control and manage liquidity risk.

Credit risk represents the possibility that a customer may not perform in accordance with contractual terms. Credit risk results from extending credit to customers, purchasing securities, and entering into certain off-balance sheet loan funding commitments. First Priority's primary credit risk occurs in the loan portfolio. First Priority uses its credit policy and disciplined approach to evaluating the adequacy of the allowance for loan losses to control and manage credit risk. First Priority's investment policy limits the degree of the amount of credit risk that may be assumed in the investment portfolio. First Priority's principal financial market risks are liquidity risks and exposures to interest rate movements.

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

Under the supervision and with the participation of our management, including the Chairman and Chief Executive Officer and the Chief Financial Officer, we have evaluated the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report. Based on that evaluation, the Chairman and Chief Executive Officer and the Chief Financial Officer have concluded that, as of the end of such period, these disclosure controls and procedures are effective.

## Changes in Internal Control Over Financial Reporting

There have not been any changes in our internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934, as amended) during the fiscal period to which this report relates that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

### **PART II**

# **Item 1. Legal Proceedings**

A certain amount of litigation arises in the ordinary course of the business of First Priority and First Priority Bank. In the opinion of the management of First Priority, there are no proceedings pending to which First Priority or First Priority Bank is a party or to which their property is subject, that, if determined adversely to them, would be material in relation to First Priority's shareholders' equity or financial condition, nor are there any proceedings pending other than ordinary routine litigation incident to the business of First Priority and First Priority Bank. In addition, no material proceedings are pending or are known to be threatened or contemplated against First Priority or First Priority Bank by governmental authorities.

#### Item 1A. Risk Factors

Not Required

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

None.

Item 3. Defaults Upon Senior Securities

None.

**Item 4. Mine Safety Disclosures** 

None.

**Item 5. Other Information** 

None.

# Item 6. Exhibits

Exhibit No.	Title
3.1	Articles of Incorporation of First Priority Financial Corp. (incorporated by reference to Exhibit 3.1 to First Priority's Registration Statement No. 333-147950 on Form S-4 filed with the SEC on December 7, 2007)
3.2	Certificate of Designations for the "Fixed Rate Cumulative Perpetual Preferred Stock, Series A" of First Priority Financial Corp. (incorporated by reference to Exhibit 3.3 to First Priority's Annual Report on Form 10-K for the year ended December 31, 2008, filed with the SEC on March 24, 2009)
3.3	Certificate of Designations for the "Fixed Rate Cumulative Perpetual Preferred Stock, Series B" of First Priority Financial Corp. (incorporated by reference to Exhibit 3.4 to First Priority's Annual Report on Form 10-K for the year ended December 31, 2008, filed with the SEC on March 24, 2009)
3.4	Certificate of Designations for the "Fixed Rate Cumulative Perpetual Preferred Stock, Series C" of First Priority Financial Corp. (incorporated by reference to Exhibit 2.1 to First Priority's Registration Statement No. 333-183118 on Form S-4 filed with the SEC on January 25, 2013)
3.5	Bylaws of First Priority Financial Corp. (incorporated by reference to Exhibit 3.2 to First Priority's Registration Statement No. 333-147950 on Form S-4 filed with the SEC on December 7, 2007)
31.1	Certification of Chief Executive Officer in accordance with Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Chief Financial Officer in accordance with Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Chief Executive Officer in accordance with Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification of Chief Financial Officer in accordance with Section 906 of the Sarbanes-Oxley Act of 2002
101	Interactive data files pursuant to Rule 405 of Regulation S-T: (i) the Consolidated Balance Sheets as of September 30, 2013 and December 31, 2012, (ii) the Consolidated Statements of Operations and Comprehensive Income (Loss) for the three and six months ended September 30, 2013 and 2012, (iii) the Consolidated Statements of Changes in Equity for the three and six months ended September 30, 2013 and 2012, (iv) the Consolidated Statements of Cash Flows for the six months ended September 30, 2013 and 2012, and (v) the Condensed Notes to Consolidated Financial Statements.

# **SIGNATURES**

In accordance with the requirements of the Exchange Act, the Registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

FIRST PRIORITY FINANCIAL CORP.

(Registrant)

Dated: November 13, 2013

By /s/ David E. Sparks
David E. Sparks,
Chairman and Chief Executive Officer

Dated: November 13, 2013 By /s/ Mark J. Myers

Mark J. Myers Chief Financial Officer

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# **Exhibit Index**

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3.3	Certificate of Designations for the "Fixed Rate Cumulative Perpetual Preferred Stock, Series B" of First Priority Financial Corp. (incorporated by reference to Exhibit 3.4 to First Priority's Annual Report on Form 10-K for the year ended December 31, 2008, filed with the SEC on March 24, 2009)
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## Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer **CERTIFICATION**

- I, David E. Sparks, Chairman and Chief Executive Officer of First Priority Financial Corp., certify that:
  - 1. I have reviewed this Quarterly Report on Form 10-Q of First Priority Financial Corp., 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)) for the registrant and have:
  - 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) Intentionally omitted pursuant to Rule 15d-15;
  - 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
  - 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.
- 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):
  - 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.

Dated: November 13, 2013 /s/ David E. Sparks

David E. Sparks,

Chairman and Chief Executive Officer

## Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer CERTIFICATION

- I, Mark J. Myers, Chief Financial Officer of First Priority Financial Corp., certify that:
  - 1. I have reviewed this Quarterly Report on Form 10-Q of First Priority Financial Corp.;
- 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)) 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) Intentionally omitted pursuant to Rule 15d-15;
  - (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.
- 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.

Dated: November 13, 2013

/s/ Mark J. Myers

Mark J. Myers

Chief Financial Officer

## CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350, SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report of First Priority Financial Corp. (the "Company") on Form 10-Q for the period ended September 30, 2013, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Mark J. Myers, Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 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) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: November 13, 2013 /s/ Mark J. Myers

Mark J. Myers Chief Financial Officer

## CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350, SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report of First Priority Financial Corp. (the "Company") on Form 10-Q for the period ended September 30, 2013, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, David E. Sparks, Chairman and Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 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) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: November 13, 2013 /s/ David E. Sparks

David E. Sparks,

Chairman and Chief Executive Officer