

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

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer
(Do not check if a smaller reporting company)

Smaller reporting company

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

YES NO

The number of outstanding shares of Common Stock of Fidelity D & D Bancorp, Inc. at April 30, 2008, the latest practicable date, was 2,075,182 shares.

FIDELITY D & D BANCORP, INC.

Form 10-Q March 31, 2008

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PART I Financial Information**Item 1: Financial Statements****FIDELITY D & D BANCORP, INC. AND SUBSIDIARY**

Consolidated Balance Sheets

	March 31, 2008 (unaudited)	December 31, 2007 (audited)
Assets:		
Cash and due from banks	\$ 13,302,358	\$ 10,204,714
Federal funds sold	9,900,000	
Interest-bearing deposits with financial institutions	176,596	204,102
Total cash and cash equivalents	23,378,954	10,408,816
Available-for-sale securities	135,212,002	121,836,851
Held-to-maturity securities	1,108,022	1,147,309
Federal Home Loan Bank Stock	3,387,800	3,302,900
Loans and leases, net (allowance for loan losses of \$ 4,378,924 in 2008; \$4,824,401 in 2007)	393,989,244	421,424,379
Loans available-for-sale (fair value \$1,228,281 in 2008; \$842,923 in 2007)	1,214,600	827,250
Bank premises and equipment, net	12,947,438	12,964,932
Cash surrender value of bank owned life insurance	8,564,950	8,488,663
Other assets	11,115,787	4,403,723
Accrued interest receivable	2,790,700	2,500,696
Foreclosed assets held-for-sale	167,036	107,036
Total assets	\$ 593,876,533	\$ 587,412,555
Liabilities:		
Deposits:		
Interest-bearing	\$ 386,356,675	\$ 360,912,740
Non-interest-bearing	69,486,801	64,795,621
Total deposits	455,843,476	425,708,361
Accrued interest payable and other liabilities	9,465,660	4,147,869
Short-term borrowings	9,879,537	39,656,354
Long-term debt	62,494,906	62,708,677
Total liabilities	537,683,579	532,221,261
Shareholders' equity:		
Preferred stock authorized 5,000,000 shares with no par value; none issued		
Capital stock authorized 10,000,000 shares with no par value; issued and outstanding, 2,075,182 shares in 2008 and 2,072,929 shares in 2007	19,349,045	19,223,363
Retained earnings	37,134,309	36,564,157

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Accumulated other comprehensive loss	(290,400)	(596,226)
Total shareholders' equity	56,192,954	55,191,294
Total liabilities and shareholders' equity	\$ 593,876,533	\$ 587,412,555

See notes to consolidated financial statements

FIDELITY D & D BANCORP, INC. AND SUBSIDIARY

Consolidated Statements of Income

(unaudited)

	Three Months Ended	
	March 31, 2008	March 31, 2007
Interest income:		
Loans and leases:		
Taxable	\$ 6,809,134	\$ 7,175,029
Nontaxable	78,076	109,517
Interest-bearing deposits with financial institutions	1,106	2,792
Investment securities:		
U.S. government agency and corporations	1,253,181	919,288
States and political subdivisions (nontaxable)	144,130	124,839
Other securities	375,036	245,899
Federal funds sold	84,169	54,452
Total interest income	8,744,832	8,631,816
Interest expense:		
Deposits	3,233,736	3,334,023
Securities sold under repurchase agreements	67,153	115,457
Other short-term borrowings and other	64,822	73,073
Long-term debt	832,285	805,073
Total interest expense	4,197,996	4,327,626
Net interest income	4,546,836	4,304,190
Provision for loan losses		
Net interest income after provision for loan losses	4,546,836	4,304,190
Other income:		
Service charges on deposit accounts	763,269	632,317
Gain (loss) on sale of:		
Loans	91,606	36,725
Investment securities	1,134	
Premises and equipment		96,557
Foreclosed assets held-for-sale	8,704	15,128
Fees and other service charges	430,829	432,936
Total other income	1,295,542	1,213,663
Other expenses:		
Salaries and employee benefits	2,417,546	2,134,977
Premises and equipment	790,640	805,825
Advertising	168,356	159,005
Other	1,016,207	1,013,236
Total other expenses	4,392,749	4,113,043

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Income before provision for income taxes	1,449,629	1,404,810
Provision for income taxes	360,682	360,459
Net income	\$ 1,088,947	\$ 1,044,351
Per share data:		
Net income - basic	\$ 0.52	\$ 0.51
Net income - diluted	\$ 0.52	\$ 0.51
Dividends	\$ 0.25	\$ 0.22

See Notes to Consolidated Financial Statements

FIDELITY D & D BANCORP, INC. AND SUBSIDIARY

Consolidated Statements of Changes in Shareholders' Equity
For the three months ended March 31, 2008 and 2007

	Shares	Capital stock Amount	Retained earnings	Accumulated other comprehensive income (loss)	Total
Balance, December 31, 2006 (audited)	2,057,433	\$ 18,702,537	\$ 33,874,118	\$ (964,792)	\$ 51,611,863
Total comprehensive income:					
Net income			1,044,351		1,044,351
Change in net unrealized holding losses on available-for-sale securities, net of reclassification adjustment and tax effects				159,150	159,150
Change in cash flow hedge intrinsic value				59,256	59,256
Comprehensive income					1,262,757
Issuance of common stock through Employee Stock Purchase Plan	2,266	67,820			67,820
Dividends reinvested through Dividend Reinvestment Plan	3,658	137,175			137,175
Stock-based compensation expense		6,958			6,958
Cash dividends declared			(453,134)		(453,134)
Balance, March 31, 2007 (unaudited)	2,063,357	\$ 18,914,490	\$ 34,465,335	\$ (746,386)	\$ 52,633,439
Balance, December 31, 2007 (audited)	2,072,929	\$ 19,223,363	\$ 36,564,157	\$ (596,226)	\$ 55,191,294
Total comprehensive income:					
Net income			1,088,947		1,088,947
Change in net unrealized holding losses on available-for-sale securities, net of reclassification adjustment and tax effects				(59,310)	(59,310)
Change in cash flow hedge intrinsic value				365,136	365,136
Comprehensive income					1,394,773
Issuance of common stock through Employee Stock Purchase Plan	2,253	57,891			57,891
Dividends reinvested through Dividend Reinvestment Plan					
Stock-based compensation expense		67,791			67,791
Cash dividends declared			(518,795)		(518,795)
Balance, March 31, 2008 (unaudited)	2,075,182	\$ 19,349,045	\$ 37,134,309	\$ (290,400)	\$ 56,192,954

See Notes to Consolidated Financial Statements

FIDELITY DEPOSIT & DISCOUNT BANCORP, INC. AND SUBSIDIARY

Consolidated Statements of Cash Flows

(unaudited)

	Three Months Ended	
	March 31, 2008	March 31, 2007
Cash flows from operating activities:		
Net income	\$ 1,088,947	\$ 1,044,351
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation, amortization and accretion	143,933	294,105
Deferred income tax expense (benefit)	159,737	(63,692)
Stock-based compensation expense	67,791	6,958
Loss from investment in limited partnership	20,100	20,100
Proceeds from sale of loans available-for-sale	33,446,667	3,998,013
Originations of loans available-for-sale	(4,096,160)	(4,210,038)
Increase in cash surrender value of life insurance	(76,287)	(76,816)
Net gain on sale of loans	(91,606)	(36,725)
Net gain on sale of investment securities	(1,134)	
Net gain on sale of foreclosed assets held-for-sale	(8,704)	(15,128)
Net gain on disposal of premises and equipment		(96,557)
Change in:		
Accrued interest receivable	(290,004)	(111,836)
Other assets	(950,950)	(301,492)
Accrued interest payable and other liabilities	56,470	(192,854)
Net cash provided by operating activities	29,468,800	258,389
Cash flows from investing activities:		
Held-to-maturity securities:		
Proceeds from maturities, calls and principal pay-downs	39,133	199,356
Available-for-sale securities:		
Proceeds from sales	12,881,733	
Proceeds from maturities, calls and principal pay-downs	15,104,801	4,187,592
Purchases	(41,209,106)	(4,943,639)
Net (increase) decrease in FHLB stock	(84,900)	196,500
Net increase in loans and leases	(2,324,907)	(270,967)
Proceeds from sale of premises and equipment		247,008
Acquisition of bank premises and equipment	(651,129)	(643,661)
Proceeds from sale of foreclosed assets held-for-sale	62,090	172,814
Net cash used in investing activities	(16,182,285)	(854,997)
Cash flows from financing activities:		
Net increase in deposits	30,135,115	3,732,401
Net decrease in short-term borrowings	(29,776,817)	(2,048,184)
Repayments of long-term debt	(213,771)	(204,580)
Proceeds from employee stock purchase plan	57,891	67,820
Dividends paid, net of dividends reinvested	(518,795)	(315,959)
Net cash (used in) provided by financing activities	(316,377)	1,231,498

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Net increase in cash and cash equivalents	12,970,138	634,890
Cash and cash equivalents, beginning	10,408,816	13,800,848
Cash and cash equivalents, ending	\$ 23,378,954	\$ 14,435,738

See notes to consolidated financial statements

FIDELITY D & D BANCORP, INC.

Notes to Consolidated Financial Statements

(unaudited)

1. Nature of operations and critical accounting policies

Nature of operations

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

Principles of consolidation

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The accompanying unaudited consolidated financial statements of the Company and the Bank have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) for interim financial information and with the instructions to this Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnote disclosures required by GAAP for complete financial statements. In the opinion of management, all normal recurring adjustments necessary for a fair presentation of the financial condition and results of operations for the periods have been included. All significant inter-company balances and transactions have been eliminated in consolidation. Prior period amounts are reclassified when necessary to conform to the current period's presentation.

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reported periods. Actual results could differ from those estimates. For additional information and disclosures required under GAAP, refer to the Company's Annual Report on Form 10-K for the year ended December 31, 2007.

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

In the opinion of management, the consolidated balance sheets as of March 31, 2008 and December 31, 2007 and the related consolidated statements of income for the three-month periods ended March 31, 2008 and 2007 and changes in shareholders' equity and cash flows for the three month periods ended March 31, 2008 and 2007 present fairly the financial condition and results of operations of the Company. All material adjustments required for a fair presentation have been made. These adjustments are of a normal recurring nature.

This Quarterly Report on Form 10-Q should be read in conjunction with the Company's audited financial statements for the year ended December 31, 2007, and the notes included therein, included within the Company's Annual Report filed on Form 10-K.

Critical accounting policies

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

A material estimate that is particularly susceptible to significant change relates to the determination of the allowance for loan losses. Management believes that the allowance for loan losses at March 31, 2008 is adequate and reasonable. Given the subjective nature of identifying and valuing loan losses, it is likely that well-informed individuals could make different assumptions, and could, therefore calculate a materially different allowance value. While management uses available information to recognize losses on loans, changes in economic conditions may necessitate revisions in the future. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Company's allowance for loan losses. Such agencies may require the Company to recognize adjustments to the allowance based on their judgment of information available to them at the time of their examination.

Another material estimate is the calculation of fair values of the Company's investment securities. The Company receives estimated fair values of investment securities from an independent valuation service. In developing these fair values, the valuation service uses estimates of cash flows, based on historical performance of similar instruments in similar interest rate environments. Based on experience, management is aware that estimated fair values of investment securities tend to vary among valuation services. Accordingly, when selling investment securities, management may obtain price quotes from more than one source. Available-for-sale (AFS) securities are carried at fair value on the consolidated balance sheet with unrealized gains and losses, net of income tax, reported separately within shareholders' equity through accumulated other comprehensive income (loss).

The fair value of residential mortgage loans originated and classified as AFS, is obtained from the Federal National Mortgage Association (FNMA). Generally, the market to which the Company sells mortgages it originates for sale is restricted and price quotes from other sources are not typically obtained. On occasion, the Company may transfer loans from the loan and lease portfolio to loans AFS. Under these rare circumstances, pricing may be obtained from other entities and the loans are transferred at the lower of cost or market value and simultaneously sold.

2. Earnings per share

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

In the computation of diluted EPS, the Company uses the treasury stock method to determine the dilutive effect of its granted but unexercised stock options. Under the treasury stock method, the assumed proceeds received from shares issued, in a hypothetical stock option exercise, are assumed to be used to purchase treasury stock. For a further discussion on the Company's stock option plans, see Note No. 3, Stock plans, below.

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

Three months ended March 31,	2008	2007
Basic EPS:		
Net income available to common shareholders	\$ 1,088,947	\$ 1,044,351
Weighted-average common shares outstanding	2,075,033	2,060,517
Basic EPS	\$ 0.52	\$ 0.51
Diluted EPS:		
Net income available to common shareholders	\$ 1,088,947	\$ 1,044,351
Weighted-average common shares outstanding	2,075,033	2,060,517
Dilutive potential common shares		1,042
Weighted-average common shares and dilutive potential shares	2,075,033	2,061,559
Diluted EPS	\$ 0.52	\$ 0.51

3. Stock plans

The Company uses the fair value method of accounting for stock-based compensation provided under Statement of Financial Accounting Standard (SFAS) No. 123R, *Share Based Payment*. SFAS 123R requires that the cost of share-based payment transactions (including those with employees and non-employees) be recognized in the financial statements. SFAS 123R applies to all share-based payment transactions in which an entity acquires goods or services by issuing (or offering to issue) its shares, share options, or other equity instruments (except for those held by an ESOP) or by incurring liabilities (1) in amounts based (even in part) on the price of the entity's shares or other equity instruments, or (2) that require (or may require) settlement by the issuance of an entity's shares or other equity instruments.

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The Company has two stock-based compensation plans (the stock option plans). The stock option plans were shareholder-approved and permit the grant of share-based compensation awards to its directors, key officers and certain other employees. The Company believes that these stock option plans better align the interest of its directors, key officers and employees with the interest of its shareholders. The Company further believes that the granting of share-based awards, under the provisions of the stock option plans, is necessary to retain the knowledge base, continuity and expertise of its directors, key officers and certain employees.

Under the stock option plans, options are granted with an exercise price equal to the market price of the Company's stock at the date of grant. The awards vest based on six months of continuous service from the date of grant and have 10-year contractual terms. Stock-based compensation expense is recognized over the six-month vesting period. Generally, all shares that are granted become fully vested.

The Company established the 2000 Independent Directors Stock Option Plan and has reserved 55,000 shares of its un-issued capital stock for issuance under the plan. No stock options were awarded during the first three months of 2008. No stock options were awarded during the first quarter of 2007. As of March 31, 2008, there were 32,350 unexercised stock options outstanding under this plan.

The Company also established the 2000 Stock Incentive Plan and has reserved 55,000 shares of its un-issued capital stock for issuance under the plan. During the first quarter of 2008, 2,000 stock options were issued under this plan at a weighted-average grant-date fair value of \$4.85 per share as determined using the Black-Scholes Option Pricing Valuation Model. The model considers expected volatility, expected dividends, risk-free interest rate and the expected term. No stock options were awarded during the first quarter of 2007. As of March 31, 2008, there were 12,830 unexercised stock options outstanding under this plan.

The following tables illustrates the stock-based compensation expense recognized during the three months ended March 31, 2008 and 2007 and the unrecognized stock-based compensation expense as of March 31, 2008 and December 31, 2007:

	Three months ended	
	2008	2007
Stock-based compensation expense:		
Director's Plan	\$ 48,471	\$
Incentive Plan	16,380	
Total stock-based compensation expense	\$ 64,851	\$

	As of:	
	March 31, 2008	December 31, 2007
Unrecognized stock-based compensation expense:		
Director's Plan	\$ 42,079	\$ 90,550
Incentive Plan	19,182	25,872
Unrecognized stock-based compensation expense	\$ 61,261	\$ 116,422

The amount unrecognized as of March 31, 2008 will be recognized during the second and third quarters of 2008. Stock-based compensation is recorded in the consolidated income statement as a component of salaries and employee benefits.

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In addition to the two stock option plans, the Company established the 2002 Employee Stock Purchase Plan (the ESPP) and reserved 110,000 shares of its un-issued capital stock for issuance under the plan. The plan was designed to promote broad-based employee ownership of the Company's stock. Under the ESPP, employees may elect to purchase the Company's capital stock at a discounted price based on the fair market value of the Company's capital stock on either the commencement date or termination date. At March 31, 2008, 10,570 shares have been issued under the ESPP. The Company recognizes compensation expense on its ESPP on the date the shares are purchased. For the three months ended March 31, 2008 and 2007, compensation expense related to the ESPP approximated \$3,000 and \$7,000, respectively, and is included as a component of salaries and employee benefits in the consolidated statements of income.

4. Derivative instruments

As part of the Company's overall interest rate risk management strategy, the Company has adopted a policy whereby it may periodically use derivative instruments to minimize significant fluctuations in earnings caused by interest rate volatility. This interest rate risk management strategy entails the use of interest rate floors, caps and swaps. During the fourth quarter of 2006, the Company entered into a three-year interest rate floor derivative agreement on \$20,000,000 notional value of its prime-based loan portfolio. The transaction required the payment of a premium by the Company to the seller for the right to receive payments in the event national prime drops below a pre-determined level (strike rate), essentially converting floating rate loans to fixed rate loans when prime drops below the contractual strike rate. When purchased, the Company recorded an asset representing the fair value of the hedge at the time of purchase. The Company has designated this agreement as a cash flow hedge pursuant to SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*. Accordingly, the change in the fair value of the instrument related to the hedge's intrinsic value, or approximately \$365,000 and \$59,000 for the three months ended March 31, 2008 and 2007, respectively, is recorded as a component of other comprehensive income (OCI) in the consolidated statement of changes in shareholders' equity and the portion of the change in fair value related to the time value expiration, or approximately \$23,000 and \$51,000 for the three months ended March 31, 2008 and 2007, respectively, is recorded in the consolidated statements of income as a reduction of interest income. No gain or loss has been recognized in earnings due to hedge ineffectiveness as of March 31, 2008. As of March 31, 2008, the Company does not expect to reclassify any amount from OCI to earnings over the next twelve months and no hedge has been discontinued. Also, as of March 31, 2008 and December 31, 2007, the fair value of the derivative contract approximated \$782,000 and \$441,000 and is recorded as a component of other assets in the consolidated balance sheet.

5. Recent accounting pronouncements

On January 1, 2008, the Company adopted SFAS 157, *Fair Value Measurements*. SFAS 157 defines fair value, establishes a framework for measuring fair value and enhances disclosures about fair value measurements required under other accounting pronouncements, but does not change existing guidance as to whether or not an instrument is carried at fair value. SFAS 157 establishes a valuation hierarchy for disclosure of the inputs to valuation used to measure fair value. This hierarchy prioritizes the inputs into three broad levels as follows. Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities. Level 2 inputs are quoted prices for similar assets and liabilities in active markets; quoted prices for identical or similar assets or liabilities in markets that are not active; or inputs that are observable for the asset or liability, either directly or indirectly through market corroboration, for substantially the full term of the financial instrument. Level 3 inputs are unobservable inputs based on our own assumptions to measure assets and liabilities at fair value. Level 3 pricing for securities may also include unobservable inputs based upon broker traded transactions. A financial asset or liability's classification within the hierarchy is determined based on the lowest level input that is significant to the fair value measurement. The adoption of this statement had no effect on the Company's financial statements.

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

	Total carrying value at March 31, 2008	Fair value measurements at March 31, 2008 using:		
		Quoted prices in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Assets:				
Available-for-sale securities	\$ 135,212	\$ 467	\$ 115,202	\$ 19,543
Loans available-for-sale	1,215		1,215	
Derivative instrument	782		782	
Total	\$ 137,209	\$ 467	\$ 117,199	\$ 19,543

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Equity securities in the available-for-sale securities portfolio are measured at fair value using quoted market prices for identical assets and are classified within Level 1 of the valuation hierarchy. Other than the Company's investment in corporate bonds, all other debt securities in the available-for-sale securities portfolio are measured at fair value using quoted prices from an independent third party that provide valuation services for similar assets, with similar terms in actively traded markets. The Company's investment in investment-grade preferred trust securities, classified under corporate bonds, the exit-pricing of which is obtained from a third party includes both observable and unobservable inputs. Due to the recent, temporary limited market activity in these instruments, a large portion of the unobservable inputs are subjective in nature and therefore, are considered Level 3 inputs. Once the market activity, including new issues, begins to occur regularly, and

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the unobservable subjective inputs are replaced by market activity, these securities may be transferred out of Level 3 into a Level 2 classification by management. Loans available-for-sale are measured at fair value from quotes received through secondary market sources, i.e., FNMA, who provides pricing for similar assets with similar terms in actively traded markets. The derivative instrument, included in other assets, is measured at fair value from pricing provided by a third party who considers observable interest rates, forward yield curves at commonly quoted intervals and volatility.

The following table illustrates the changes in Level 3 financial instruments measured at fair value on a recurring basis (dollars in thousands):

Assets:	Available-for-sale securities	
Balance January 1, 2008	\$	16,335
Realized / unrealized gains (losses):		
in earnings		
in comprehensive income		(1,341)
Purchases, sales, issuances and settlements amortization and accretion, net		4,549
Transfers into (out of) Level 3		
Balance March 31, 2008	\$	19,543

The following table illustrates the financial instruments measured at fair value on a nonrecurring basis segregated by hierarchy fair value levels (dollars in thousands):

Assets:	Total carrying value at March 31, 2008	Fair value measurements at March 31, 2008 using:			
		Quoted prices in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)	
Impaired loans	\$ 2,223	\$ 16	\$ 1,018	\$ 1,189	

Impaired loans that are collateral dependent are written down to fair value through the establishment of specific reserves. Techniques used to value the collateral that secure the impaired loan include: quoted market prices for identical assets classified as Level 1 inputs; observable inputs, employed by certified appraisers, for similar assets classified as Level 2 inputs. In cases where valuation techniques included inputs that are unobservable and are based on estimates and assumptions developed by management based on the best information available under each circumstance, the asset valuation is classified as Level 3 inputs.

On January 1, 2008, the Company adopted SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. SFAS 159 allows companies to elect to follow fair value accounting for certain financial assets and liabilities in an effort to mitigate volatility in earnings without having to apply complex hedge accounting provisions. The Company did not elect the fair value option for any of its financial instruments as of March 31, 2008 and therefore the adoption of this statement had no effect on the Company's financial statements.

In March 2008, the Financial Accounting Standard Board issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities*. SFAS 161 amends and expands the disclosure requirements of SFAS 133, *Accounting for Derivative Instruments and Hedging Activities*. It requires qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about fair value amounts of gains and losses on derivative instruments, and disclosures about credit-risk-related contingent features in derivative agreements. This statement is effective for financial statements issued for fiscal years beginning after November 15, 2008. The Company does not expect the

adoption of this pronouncement to have a material impact on its consolidated financial statements.

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

The following is management's discussion and analysis of the significant changes in the consolidated financial condition of the Company as of March 31, 2008 compared to December 31, 2007 and the results of operations for the three months ended March 31, 2008 and March 31, 2007. Current performance may not be indicative of future results. This discussion should be read in conjunction with the Company's 2007 Annual Report filed on Form 10-K.

Forward-looking statements

This Interim Report on Form 10-Q contains a number of forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, or the Securities Act, and Section 21E of the Securities Exchange Act of 1934, as amended, or the Exchange Act. These statements may be identified by the use of the words anticipate, believe, could, estimate, expect, intend, may, outlook, plan, project, should, will, would and similar terms and phrases, including references to assumptions. Forward-looking statements include risks and uncertainties.

Forward-looking statements are based on various assumptions and analyses made by us in light of management's experience and its perception of historical trends, current conditions and expected future developments, as well as other factors management believes are appropriate under the circumstances. These statements are not guarantees of future performance and are subject to risks, uncertainties and other factors (many of which are beyond our control) that could cause actual results to differ materially from future results expressed or implied by such forward-looking statements. These factors include, without limitation, the following:

- the timing and occurrence or non-occurrence of events may be subject to circumstances beyond our control;
- there may be increases in competitive pressure among financial institutions or from non-financial institutions;
- changes in the interest rate environment may reduce interest margins;
- changes in deposit flows, loan demand or real estate values may adversely affect our business;
- changes in accounting principles, policies or guidelines may cause our financial condition to be perceived differently;

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- general economic conditions, either nationally or locally in some or all areas in which we do business, or conditions in the securities markets or the banking industry may be less favorable than we currently anticipate;
- legislative or regulatory changes may adversely affect our business;
- technological changes may be more rapid, difficult or expensive than we anticipate;
- success or consummation of new business initiatives may be more difficult or expensive than we anticipate;
- acts of war or terrorism; or
- natural disaster.

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

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

General

The Company's principal revenues are derived from interest, dividends and fees earned on its interest-earning assets, which are comprised of loans, securities and other short-term investments. The Company's principal expenses consist of interest paid on its interest-bearing liabilities, which are comprised of deposits, short-and long-term borrowings and operating and general expenses. The Company's profitability depends primarily on its net interest income. Net interest income is the difference between interest income and interest expense. Interest income is generated from yields on interest-earning assets which consist principally of loans and investment securities. Interest expense is incurred from rates paid on interest-bearing liabilities, which consist of deposits and borrowings. Net interest income is dependent upon the interest-rate spread (i.e., the difference between the yields earned on its interest-earning assets and the rates paid on its interest-bearing liabilities) and the relative amounts of interest-earning assets and interest-bearing liabilities. The interest rate spread is significantly impacted by: changes in interest rates and market yield curves and their related impact on cash flows; the composition and characteristics of interest-earning assets and interest-bearing liabilities; differences in the maturity and re-pricing characteristics of assets compared to the maturity and re-pricing characteristics of the liabilities that fund them and by the competition in our marketplace.

The Company's profitability is also affected by the level of its non-interest income and expenses, provision for loan losses and provision for income taxes. Non-interest income consists mostly of service charges on the Bank's loan and deposit products, trust and asset management service fees, increases in the cash surrender value of the bank owned life insurance (BOLI), net gains or losses from sales of loans and securities AFS and from the sales of other real estate (ORE) properties. Non-interest expense consists of compensation and related employee benefit expenses, occupancy, equipment, data processing, advertising, marketing, professional fees, insurance and other operating overhead.

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

COMPARISON OF RESULTS OF OPERATIONS

THREE MONTHS ENDED MARCH 31, 2008 AND MARCH 31, 2007

Overview

Net income for the three months ended March 31, 2008 was \$1,089,000, a 4% increase compared to \$1,044,000 recorded for the three months ended March 31, 2007. Diluted earnings per share were \$0.52 and \$0.51 for each of the respective periods. The increase in net income was the result of increases in net interest income and non-interest income, partially offset by increases in non-interest expense and the provision for income taxes.

Return on average assets (ROA) and return on average shareholders' equity (ROE) were 0.74% and 7.80%, respectively, for the three months ended March 31, 2008 compared to 0.75% and 8.12%, respectively, for the same period in 2007. The increase in net income had a positive influence on both ROA and ROE for the comparable periods; however, the decline in ROE was caused by a higher balance of average equity in

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the current period fueled by higher retained earnings. The decrease in ROA was caused by a higher balance of average assets at the end of the 2008 quarter compared to the end of the 2007 quarter.

Net interest income and interest sensitive assets / liabilities

Net interest income increased \$243,000 to \$4,547,000 for the first quarter of 2008, from \$4,304,000 recorded in the same period of 2007. The increase in net interest income was principally due to a combination of: \$24,000,000 in growth of average earning assets mostly in the investment portfolio which increased by approximately \$30,000,000 in the first quarter 2008 compared to the first quarter of 2007; and lower rates paid on interest-bearing deposits during the same period. Growth in the investment portfolio was the result of deposit growth and the sale of relatively low yielding, long-term mortgage loans, the proceeds of which were used to purchase better yielding investments. As a result, interest income from the investment and loan portfolios and federal funds sold combined for a net increase of approximately \$113,000 in the first quarter of 2008 compared to the first quarter of 2007. Contributing to the improvement in net interest income was lower interest expense which decreased \$130,000, or 3%, in the current year quarter compared to last year's first quarter. Though interest-bearing deposits increased by \$26,000,000, on average, rates on deposits have been reducing in concert with the current interest rate environment. Average rates paid on deposits have declined 40

basis points for the three months ended March 31, 2008 compared to the three months ended March 31 2007. This reduction in rate had a greater influence on interest expense than the increase in average balances, both of which combined for a net reduction in interest expense from deposits of \$100,000.

During the first quarter of 2008, the Bank's tax-equivalent margin and spread were 3.37% and 2.76%, respectively, compared to 3.36% and 2.66% during the first quarter of 2007. The improvement in both spread and margin were from combined increased interest income and decreased interest expense and the resulting higher level of net interest income.

The inverted treasury yield curve that was prevalent in 2006 and 2007 has turned positive and continues to steepen. The Federal Open Market Committee (FOMC) has reduced fed funds interest rate by 300 basis points since the end of the first quarter of 2007 and 200 basis points since year-end 2007. In turn, the national prime rate, the benchmark rate banks use to set rates on various lending and other interest sensitive financial instruments, has been reduced by similar amounts during the same periods. Generally, this situation causes floating rate assets to re-price at lower yields, and also causes fixed rate assets to originate at yields lower than the yields earned in the prior comparable period, thereby reducing interest income. To help mitigate this effect, the Company sold \$28,100,000 of low yielding mortgage loans and used the proceeds to pay down borrowings and purchase investment securities.

The Company's Asset Liability Management team meets regularly to discuss interest rate risk and if necessary adjust interest rates on paying deposits in response to rate movements that emanate from the FOMC so that net interest income is not disproportionately impacted during this down-rate environment. This proactive attention to interest rate risk in conjunction with our interest rate hedging strategy, as described in Note No. 4, Derivative instruments, within the notes to the consolidated financial statements in Part I, Item 1, has helped contain the Company's net interest income at an acceptable level.

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

	Three months ended March 31,		Year ended December 31,
	2008	2007	2007
<u>Average interest-earning assets:</u>			
Loans and leases	\$ 411,093	\$ 425,380	\$ 424,781
Investments	134,492	104,521	116,217
Federal funds sold	12,175	4,178	1,948
Interest-bearing deposits	152	211	184
Total	\$ 557,912	\$ 534,290	\$ 543,130
<u>Average interest-bearing liabilities:</u>			
Other interest-bearing deposits	\$ 191,295	\$ 200,164	\$ 194,452
Certificates of deposit	189,601	154,738	161,418
Borrowed funds	68,697	67,400	71,573
Repurchase agreements	15,372	17,873	19,580
Total	\$ 464,965	\$ 440,175	\$ 447,023
<u>Interest income (FTE):</u>			
Loans and leases	\$ 6,928	\$ 7,341	\$ 29,477
Investments	1,856	1,362	6,219
Federal funds sold	84	54	103
Interest-bearing deposits	1	3	9
Total	\$ 8,869	\$ 8,760	\$ 35,808
<u>Interest expense:</u>			
Other interest-bearing deposits	\$ 1,094	\$ 1,630	\$ 6,029
Certificates of deposit	2,140	1,705	7,341
Borrowed funds	897	878	3,825
Repurchase agreements	67	115	465
Total	\$ 4,198	\$ 4,328	\$ 17,660
Net interest income (FTE)	\$ 4,671	\$ 4,432	\$ 18,148
<u>Yield on average interest-earning assets</u>			
Loans and leases	6.78%	7.00%	6.94%
Investments	5.55%	5.28%	5.35%
Federal funds sold	2.78%	5.29%	5.28%
Interest-bearing deposits	2.93%	5.36%	4.81%
Total	6.39%	6.65%	6.59%
<u>Rates on average interest-bearing liabilities</u>			
Other interest-bearing deposits	2.30%	3.30%	3.10%
Certificates of deposit	4.54%	4.47%	4.55%
Borrowed funds	5.25%	5.28%	5.34%
Repurchase agreements	1.76%	2.62%	2.38%
Total	3.63%	3.99%	3.95%
Net interest spread	2.76%	2.66%	2.64%
Net interest margin	3.37%	3.36%	3.34%

In the table above, interest income was adjusted to a tax-equivalent basis to recognize the income from the various tax-exempt assets as if the interest was fully taxable. This treatment allows a uniform comparison among the yields on interest-earning assets. The calculations were

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computed on a fully tax-equivalent basis using the corporate federal tax rate of 34%. Net interest spread represents the difference between the yield on interest-earning assets and the rate on interest-bearing liabilities. Net interest margin represents the ratio of net interest income to total average interest-earning assets.

Provision for loan losses

The provision for loan losses represents the necessary amount to charge against current earnings, the purpose of which is to increase the allowance for loan losses to a level that represents management's best estimate of known and inherent losses in

the Company's loan portfolio. Loans and leases determined to be uncollectible are charged-off against the allowance for loan losses. The required amount of the provision for loan losses, based upon the adequate level of the allowance for loan losses, is subject to ongoing analysis of the loan portfolio. The Bank's Special Asset Committee meets periodically to review problem loans and leases. The committee is comprised of Bank management, including the chief risk officer, loan workout officers and collection personnel. The committee reports quarterly to the Credit Administration Committee of the Board of Directors.

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

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

No provisions for loan losses were necessary during the first quarter of 2008. After taking into account charge-offs and recoveries, the allowance for loan losses was \$4,379,000 at March 31, 2008 as compared to \$5,360,000 as of March 31, 2007. Although the non-accrual loans have increased compared to balances at December 31, 2007 and March 31, 2007, other adversely criticized and classified loans have declined during the same periods. These reductions coupled with lower reserve allocations required for impaired loans and a reduced loan portfolio, due to the aforementioned sale of residential mortgage loans, has resulted in a lower calculated allowance for loan losses as of March 31, 2008. The lower level of the allowance has been deemed adequate to absorb the known and inherent losses in the loan portfolio at March 31, 2008 and therefore neither a provision nor a credit for loan losses was necessary. For a further discussion on the allowance for loan losses and non-accrual loans, see [Comparison of Financial Condition at March 31, 2008 and December 31, 2007](#), below.

Other income

Total other (non-interest) income improved \$82,000, or 7%, to \$1,296,000 for the three months ended March 31, 2008 from \$1,214,000 for the three months ended March 31, 2007. The Company experienced \$131,000 of growth in deposit service fees. Increased sales of residential mortgages into the secondary market have resulted in \$55,000 more net gains in the current quarter compared to the prior year quarter. During the quarter ended March 31, 2007, the Company recorded a \$97,000 gain from the sale of a commercial property that did not recur in the 2008 quarter.

Other operating expenses

For the first quarter ended March 31, 2008, other (non-interest) expenses increased \$280,000, or 7%, compared to the same 2007 quarter. Salaries and related employee benefits increased \$283,000, or 13%, due to payroll and incentive increases, an increase in the number of full-time equivalent employees, higher stock-based compensation expense and increased health insurance costs.

COMPARISON OF FINANCIAL CONDITION AT

MARCH 31, 2008 AND DECEMBER 31, 2007

Overview

Consolidated assets increased \$6,464,000 during the three months ended March 31, 2008. The increase was caused by the recording of an investment security purchase commitment of \$5,300,000, carried in other assets, scheduled to settle early in the second quarter of 2008 and an increase in shareholders' equity of \$1,002,000, predominantly from the first quarter's net income. The offset to the purchase commitment was a recording of a liability to purchase. Upon settlement, both assets and liabilities will be reduced by \$5,300,000.

Investment securities

At the time of purchase, management classifies investment securities into one of three categories: trading, AFS or held-to-maturity (HTM). To date, management has not purchased any securities for trading purposes. Most of the securities

purchased are classified as AFS even though there is no immediate intent to sell them. The AFS designation affords management the flexibility to sell securities and position the balance sheet in response to capital levels, liquidity needs or changes in market conditions. Securities AFS are carried at net fair value in the consolidated balance sheet with an adjustment to shareholders' equity, net of tax, presented under the caption Accumulated other comprehensive income (loss). Securities designated as HTM are carried at amortized cost and represent debt securities that the Company has the ability and intent to hold until maturity.

At March 31, 2008, the carrying value of investment securities totaled \$136,320,000, or 23% of total assets compared to \$122,984,000 or 21% of total assets at December 31, 2007. At March 31, 2008, approximately 40% of the carrying value of the investment portfolio was comprised of mortgage-backed securities that amortize and provide monthly cash flow. Agency, corporate and municipal bonds comprised 32%, 15% and 12%, respectively, of the investment portfolio at March 31, 2008.

Total investments increased \$13,336,000, net of a \$91,000 decline in the market value of AFS investments. The increase in the investment portfolio in the first quarter of 2008 was from liquidity created from the sale of mortgage loans. The amortized cost and fair market value of investment securities is comprised of HTM and AFS securities with carrying values of \$1,108,000 and \$135,212,000, respectively. At March 31, 2008, the AFS debt securities were recorded with a net unrealized loss in the amount of \$1,716,000 and equity securities were recorded with an unrealized gain of \$138,000. A comparison of investment securities at March 31, 2008 and December 31, 2007 is as follows (dollars in thousands):

	March 31, 2008		December 31, 2007	
	Amount	%	Amount	%
U.S. government agencies	\$ 55,177	40.5	\$ 35,244	28.6
Mortgage-backed securities	45,707	33.5	58,767	47.8
State & municipal subdivisions	15,426	11.3	12,133	9.9
Preferred term securities	19,543	14.4	16,335	13.3
Equity securities	467	0.3	505	0.4
Total investments	\$ 136,320	100.0	\$ 122,984	100.0

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The amortized cost and fair value of investments at March 31, 2008 are as follows (dollars in thousands):

	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
<u>Held-to-maturity securities:</u>				
Mortgage-backed securities	\$ 1,108	\$ 43	\$	\$ 1,151
<u>Available-for-sale securities:</u>				
U.S. government agencies and corporations	\$ 54,925	\$ 356	\$ 104	\$ 55,177
Obligations of states and political subdivisions	15,444	91	109	15,426
Corporate bonds	22,081		2,538	19,543
Mortgage-backed securities	44,011	594	6	44,599
Total debt securities	136,461	1,041	2,757	134,745
Equity securities	329	147	9	467
Total available-for-sale	\$ 136,790	\$ 1,188	\$ 2,766	\$ 135,212

The amortized cost and fair value of debt securities at March 31, 2008 by contractual maturity are as follows (dollars in thousands):

	Amortized cost	Market value
<u>Held-to-maturity securities:</u>		
Mortgage-backed securities	\$ 1,108	\$ 1,151
<u>Available-for-sale securities:</u>		
Debt securities:		
Due in one year or less	\$ 5,130	\$ 5,129
Due after one year through five years	6,006	6,046
Due after five years through ten years	12,205	12,398
Due after ten years	69,109	66,573
Total debt securities	92,450	90,146
Mortgage-backed securities	44,011	44,599
Total available-for-sale debt securities	\$ 136,461	\$ 134,745

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

Management evaluates securities for other-than-temporary impairment on a quarterly basis or more frequently when economic conditions or market conditions warrant such evaluation. Consideration is given to (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 issue for a period of time sufficient to allow for any anticipated recovery in fair value.

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At March 31, 2008, the AFS debt securities portfolio was carried at a net unrealized loss of \$1,716,000 compared to a net unrealized loss of \$1,663,000 at December 31, 2007. Management believes the cause of the unrealized losses is directly related to changes in interest rates and not credit quality, which is consistent with its experience. In addition, the Company

has the ability and intent to hold its investments for a period of time sufficient for the fair value of the securities to recover, which may be at maturity. There were no other-than-temporary impairment write-downs recorded during the three months ended March 31, 2008 nor have there been any write-downs recorded for the year-ended December 31, 2007.

Loans available-for-sale (AFS)

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

Loans AFS at March 31, 2008 amounted to \$1,215,000 with a corresponding fair value of \$1,228,000, compared to \$827,000 and \$843,000, respectively, at December 31, 2007. During the first quarter of 2008, residential mortgages with principal balances of \$33,355,000 were sold into the secondary market with net gains of approximately \$92,000 recognized. Included in the sale were \$28,100,000 of residential loans transferred from the loan and lease portfolio.

Loans and leases

The Company originates commercial and industrial (commercial) and commercial real estate (CRE) loans, residential, consumer, home equity and construction loans. The relative volume of originations is dependent upon customer demand, current interest rates and the perception and duration of future interest levels. The broad spectrum of products provides diversification that helps manage to an extent, interest rate and credit concentration risk. Credit risk is further managed through underwriting policies and procedures and loan monitoring practices. Interest rate risk is managed using various asset/liability modeling techniques and analyses. The interest rates on most commercial loans are adjustable with reset intervals of five years or less.

The majority of the Company's loan portfolio is collateralized, at least in part, by real estate in Lackawanna and Luzerne Counties of Pennsylvania. Commercial lending activities generally involve a greater degree of credit risk than residential lending because they typically have larger balances and are more affected by adverse conditions in the economy. Because payments on commercial loans depend upon the successful operation and management of the properties and the businesses which operate from within them, repayment of such loans may be affected by factors outside the borrower's control. Such factors may include adverse conditions in the real estate market, the economy, the industry or changes in government regulations. As such, commercial loans require more ongoing evaluation and monitoring which occurs with the Bank's credit administration and outsourced loan review functions.

The composition of the loan portfolio at March 31, 2008 and December 31, 2007, is summarized as follows (dollars in thousands):

March 31, 2008

December 31, 2007

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	Amount	%	Amount	%
Commercial and CRE	\$ 216,588			