

FIRST DEFIANCE FINANCIAL CORP

Form 10-K

March 07, 2012

[Table of Contents](#)

**SECURITIES AND EXCHANGE COMMISSION**

**WASHINGTON, D.C. 20549**

**FORM 10-K**

(Mark One)

☒ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the fiscal year Ended December 31, 2011

or

☐ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
Commission File Number 0-26850

**FIRST DEFIANCE FINANCIAL CORP.**

(Exact name of registrant as specified in its charter)

**OHIO**

(State or other jurisdiction of incorporation or organization)

**34-1803915**

(I.R.S. Employer Identification Number)

**601 Clinton Street, Defiance, Ohio**

(Address of principal executive offices)

**43512**

(Zip code)

Registrant's telephone number, including area code: **(419) 782-5015**

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

**Common Stock, Par Value \$0.01 Per Share**  
(Title of Class)

**The NASDAQ Stock Market**  
(Name of each exchange on which registered)

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

**None**

(Title of Class)

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

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

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 subject to such filing requirements for the past 90 days. Yes ☒ No ☐

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

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

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

Large accelerated filer ☐ Accelerated filer ☒ Non-accelerated filer ☐ 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 ☒

As of February 29, 2012, there were issued and outstanding 9,726,454 shares of the Registrant's common stock.

The aggregate market value of the voting stock held by non-affiliates of the Registrant computed by reference to the average bid and ask price of such stock as of June 30, 2011 was approximately \$137.4 million

**Documents Incorporated by Reference**

Part III of this Form 10-K incorporates by reference certain information from the registrant's definitive Proxy Statement for the 2012 Annual Shareholders' Meeting

**Table of Contents**

**First Defiance Financial Corp.**

**Annual report on Form 10-k**

**Table of Contents**

	<b>Page</b>
<b><u>PART I</u></b>	
Item 1. <u>Business</u>	3
Item 1A. <u>Risk Factors</u>	23
Item 1B. <u>Unresolved Staff Comments</u>	31
Item 2. <u>Properties</u>	31
Item 3. <u>Legal Proceedings</u>	34
Item 4. <u>Reserved</u>	34
<b><u>PART II</u></b>	
Item 5. <u>Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities</u>	34
Item 6. <u>Selected Financial Data</u>	36
Item 7. <u>Management's Discussion and Analysis of Financial Condition and Results of Operation</u>	37
Item 7A. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	61
Item 8. <u>Financial Statements and Supplementary Data</u>	63
Item 9. <u>Changes in and Disagreements With Accountants on Accounting and Financial Disclosures</u>	137
Item 9A. <u>Controls and Procedures</u>	137
Item 9B. <u>Other Information</u>	137
<b><u>PART III</u></b>	
Item 10. <u>Directors, Executive Officers and Corporate Governance</u>	137
Item 11. <u>Executive Compensation</u>	137
Item 12. <u>Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u>	138
Item 13. <u>Certain Relationships and Related Transactions, and Director Independence</u>	138
Item 14. <u>Principal Accounting Fees and Services</u>	138
<b><u>PART IV</u></b>	
Item 15. <u>Exhibits, Financial Statement Schedules</u>	139
<b><u>SIGNATURES</u></b>	140

**Table of Contents**

**PART I**

**Item 1. Business**

First Defiance Financial Corp. ( First Defiance or the Company ) is a unitary thrift holding company that, through its subsidiaries, First Federal Bank of the Midwest ( First Federal ) and First Insurance Group of the Midwest, Inc., formerly known as First Insurance and Investments, Inc. ( First Insurance ) (collectively, the Subsidiaries ), focuses on traditional banking and property and casualty and life and group health insurance products. The Company's banking activities include originating and servicing residential, commercial, and consumer loans and providing a broad range of depository services. The Company's insurance activities consist primarily of commissions relating to the sale of property and casualty and life and group health insurance products.

The Company's philosophy is to grow and prosper, building long-term relationships based on top quality service, high ethical standards and safe and sound assets. The Company operates as a locally oriented, community-based financial services organization, augmented by experienced, centralized support in select critical areas. The Company's local market orientation is reflected in its market area management and local advisory boards, which are comprised of local business persons, professionals and other community representatives that assist area management in responding to local banking needs.

The Company's operating objectives include expansion, diversification within its markets, growth of its fee-based income and growth internally and through acquisitions of financial institutions, branches and financial services businesses. The Company seeks merger or acquisition partners that are culturally similar and have experienced management and possess either significant market area presence or have the potential for improved profitability through financial management, economies of scale and expanded services. The Company regularly evaluates merger and acquisition opportunities and conducts due diligence activities related to possible transactions with other financial institutions. As a result, merger or acquisition discussions and, in some cases, negotiations may take place and future mergers or acquisitions involving cash, debt or equity securities may occur. Acquisitions typically involve the payment of a premium over book and market values and, therefore, some dilution of the Company's tangible book value and net income per common share may occur in any future transaction.

At December 31, 2011, the Company had consolidated assets of \$2.07 billion, consolidated deposits of \$1.60 billion, and consolidated stockholders' equity of \$278.1 million. The Company was incorporated in Ohio in June of 1995. Its principal executive offices are located at 601 N. Clinton Street, Defiance, Ohio 43512, and its telephone number is (419) 782-5015.

First Defiance's website, [www.fdef.com](http://www.fdef.com) contains a hyperlink under the Investor Relations section to EDGAR where the annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 are available free of charge as soon as reasonably practicable after First Defiance has filed the report with the SEC.

**The Subsidiaries**

The Company's core business operations are conducted through the Subsidiaries:

*First Federal Bank of the Midwest:* First Federal is a federally chartered stock savings bank headquartered in Defiance, Ohio. It conducts operations through 26 full service banking center offices in Allen, Defiance, Fulton, Hancock, Henry, Lucas, Ottawa, Paulding, Putnam, Seneca, Williams and Wood counties in northwest Ohio, 1 full service banking center office in Allen county in northeast Indiana and 6 full service banking center offices in Lenawee county in southeast Michigan.

## **Table of Contents**

On March 14, 2008, First Defiance completed the acquisition of Pavilion Bancorp, Inc. ( "Pavilion" ) and its subsidiary, Bank of Lenawee. That acquisition added eight banking branch offices located in Lenawee and Hillsdale counties in Michigan. The one branch in Hillsdale county that was acquired in the Pavilion acquisition was closed in January 2010. On January 21, 2005, First Defiance completed the acquisition of ComBanc, Inc. ( "ComBanc" ) and its subsidiary, the Commercial Bank, Delphos, Ohio. That acquisition added four branch offices located in Allen County, Ohio, which is adjacent to First Defiance's existing footprint. On April 8, 2005, First Defiance completed the acquisition of the Genoa Savings and Loan Company, ( "Genoa" ) which added three offices in the metropolitan Toledo, Ohio area.

First Federal is primarily engaged in community banking. It attracts deposits from the general public through its offices and uses those and other available sources of funds to originate residential real estate loans, non-residential real estate loans, commercial loans, home improvement and home equity loans and consumer loans. In addition, First Federal invests in U.S. Treasury and federal government agency obligations, obligations of the State of Ohio and its political subdivisions, mortgage-backed securities which are issued by federal agencies, including real estate mortgage investment conduits ( "REMICs" ) and collateralized mortgage obligations ( "CMOs" ), and corporate bonds. First Federal's deposits are insured by the Federal Deposit Insurance Corporation ( "FDIC" ). First Federal is a member of the Federal Home Loan Bank ( "FHLB" ) System.

*First Insurance Group:* First Insurance is a wholly owned subsidiary of First Defiance. First Insurance is an insurance agency that conducts business in the Defiance, Archbold, Maumee, Oregon, Bryan and Bowling Green, Ohio areas. First Insurance offers property and casualty insurance, life insurance and group health insurance. On July 1, 2011 First Insurance acquired Payak-Dubbs Insurance Agency, Inc. ( "PDI" ) headquartered in Maumee and Oregon, Ohio. In May 2010, First Insurance acquired a group medical benefits business line from Andres O. Neil & Lowe Insurance Agency. See Note 4 - Acquisitions in the Notes to the financial statements for additional information.

## **Securities**

First Defiance's securities portfolio is managed in accordance with a written policy adopted by the Board of Directors and administered by the Investment Committee. The Chief Financial Officer, the Chief Operating Officer, and the Chief Executive Officer of First Federal can each approve transactions up to \$3 million. Two of the three officers are required to approve transactions between \$3 million and \$5 million. All transactions in excess of \$5 million must be approved by the Board of Directors.

First Defiance's investment portfolio includes 45 CMO and REMIC issues totaling \$61.9 million, all of which are fully amortizing securities. Management does not believe the risks associated with any of its CMO or REMIC investments are significantly different from risks associated with other pass-through mortgage-backed securities. First Defiance did not have any off-balance sheet derivative securities at December 31, 2011.

Management determines the appropriate classification of debt securities at the time of purchase. Debt securities are classified as held-to-maturity when First Defiance has the positive intent and ability to hold the securities to maturity. Held-to-maturity securities are stated at amortized cost. Debt securities not classified as held-to-maturity and equity securities are classified as available-for-sale. Available-for-sale securities are stated at fair value.

**Table of Contents**

The carrying value of securities at December 31, 2011 by contractual maturity is shown below. Expected maturities will differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties. For purposes of the maturity table, mortgage-backed securities, which are not due at a single maturity date, have been allocated over maturity groupings based on the weighted-average contractual maturities of underlying collateral. The mortgage-backed securities may mature earlier than their weighted-average contractual maturities because of principal prepayments.

	Contractually Maturing								Total	
	Under 1 Year	Weighted Average Rate	1 - 5 Years	Weighted Average Rate	6-10 Years	Weighted Average Rate	Over 10 Years	Weighted Average Rate	Amount	Yield
	(Dollars in Thousands)									
Mortgage-backed securities	\$ 17,732	3.75%	\$ 33,421	3.67%	\$ 15,287	3.52%	\$ 3,496	3.31%	\$ 69,936	3.64%
REMICs and CMOs	20,732	4.51	34,277	4.02	6,370	3.75	443	3.62	61,822	4.15
U.S. treasury bonds	1,000	0.63	1,000	0.63					2,000	0.63
U.S. government and federal agency obligations			3,000	1.83	14,000	2.24			17,000	2.16
Obligations of states and political subdivisions (1)	670	3.85	1,885	4.76	18,143	3.73	45,260	4.08	65,958	4.00
Trust preferred stock and preferred stock					17		3,830	2.45	3,847	2.44
Corporate bonds			7,000	1.03	2,000	0.82			9,000	0.98
Total	\$ 40,134		\$ 80,583		\$ 55,817		\$ 53,029		\$ 229,563	
Unamortized premiums/ (discounts)									(3,220)	
Unrealized gain on securities available for sale									7,237	
Total									\$ 233,580	

(1) Tax exempt yield based on effective tax rate of 35%. Actual coupon rate is approximately equal to the weighted average rate disclosed in the table times 65%.

The carrying value of investment securities is as follows:

	2011	December 31 2010 <i>(In Thousands)</i>	2009
Available-for-sale securities:			
Obligations of U.S. government corporations and agencies	\$ 17,085	\$ 11,985	\$ 14,251
U.S. treasury bonds	2,010		
Obligations of state and political subdivisions	71,503	52,750	44,733
CMOs, REMICS and mortgage-backed securities	132,619	95,174	76,798
Trust preferred stock and preferred stock	1,450	1,546	1,676
Corporate bonds	8,252	3,797	
Total	\$ 232,919	\$ 165,252	\$ 137,458
Held-to-maturity securities:			
Mortgage-backed securities	\$ 353	\$ 440	\$ 530

# Edgar Filing: FIRST DEFIANCE FINANCIAL CORP - Form 10-K

Obligations of state and political subdivisions	<b>308</b>	399	1,390
Total	<b>\$ 661</b>	\$ 839	\$ 1,920

For additional information regarding First Defiance's investment portfolio refer to Note 6 Investment Securities to the consolidated financial statements.

-5-

**Table of Contents****Interest-Bearing Deposits**

The Company had \$143.0 million at both December 31, 2011 and 2010 in overnight investments with the Federal Reserve, which amount is included in interest-bearing deposits. First Defiance had interest-earning deposits in the FHLB of Cincinnati and other financial institutions amounting to \$1.6 million and \$1.2 million at December 31, 2011 and 2010, respectively.

**Residential Loan Servicing Activities**

Servicing mortgage loans for investors involves a contractual right to receive a fee for processing and administering loan payments on mortgage loans that are not owned by the Company and are not included on the Company's balance sheet. This processing involves collecting monthly mortgage payments on behalf of investors, reporting information to those investors on a monthly basis and maintaining custodial escrow accounts for the payment of principal and interest to investors and property taxes and insurance premiums on behalf of borrowers. At December 31, 2011, First Federal serviced 13,576 loans totaling \$1.27 billion. The vast majority of the loans serviced for others are fixed rate conventional mortgage loans. The Company primarily sells its loans to Freddie Mac, Fannie Mae and FHLB. In 2011, 58.54%, 38.89% and 2.45% of the Company's sold loans were to Freddie Mac, Fannie Mae and FHLB, respectively.

As compensation for its mortgage servicing activities, the Company receives servicing fees, usually 0.25% per annum of the loan balances serviced, plus any late charges collected from delinquent borrowers and other fees incidental to the services provided. In the event of a default by the borrower, the Company receives no servicing fees until the default is cured.

The following table sets forth certain information regarding the number and aggregate principal balance of the mortgage loans serviced by the Company, including both fixed and adjustable rate loans, at various interest rates:

Rate	2011			December 31 2010			2009		
	Number of Loans	Aggregate Principal Balance	Percentage of Aggregate Principal Balance	Number of Loans	Aggregate Principal Balance	Percentage of Aggregate Principal Balance	Number of Loans	Aggregate Principal Balance	Percentage of Aggregate Principal Balance
<i>(Dollars in Thousands)</i>									
Less than 5.00%	6,287	\$ 696,666	54.84%	5,074	\$ 576,628	45.22%	3,183	\$ 355,467	29.10%
5.00% - 5.99%	4,457	370,355	29.15	5,059	437,984	34.35	5,675	515,795	42.22
6.00% - 6.99%	2,383	177,353	13.96	2,923	229,524	18.00	3,688	310,368	25.41
7.00% - 7.99%	402	24,288	1.91	468	29,047	2.28	567	37,410	3.06
8.00% - 8.99%	42	1,523	0.12	49	1,719	0.13	56	2,140	0.18
9.00% and over	5	202	0.02	7	278	0.02	10	375	0.03
Total	13,576	\$ 1,270,387	100.00%	13,580	\$ 1,275,180	100.00%	13,179	\$ 1,221,555	100.00%

Loan servicing fees decrease as the principal balance on the outstanding loan decreases and as the remaining time to maturity of the loan shortens. The following table sets forth certain information regarding the remaining maturity of the mortgage loans serviced by the Company as of the dates shown.



**Table of Contents**

Maturity	2011				2010				2009			
	Number of Loans	% of Number of Loans	Unpaid Principal Amount	% of Unpaid Principal Amount	Number of Loans	% of Number of Loans	Unpaid Principal Amount	% of Unpaid Principal Amount	Number of Loans	% of Number of Loans	Unpaid Principal Amount	% of Unpaid Principal Amount
1-5 years	375	2.76%	\$ 6,267	0.49%	400	2.95%	\$ 12,692	1.00%	659	5.00%	\$ 37,562	3.07%
6-10 years	1,677	12.35	72,700	5.72	1,961	14.44	90,706	7.11	2,181	16.55	111,117	9.10
11-15 years	3,326	24.50	310,369	24.43	2,944	21.68	273,714	21.46	2,382	18.07	210,332	17.22
16-20 years	1,026	7.56	99,650	7.84	865	6.37	84,865	6.66	682	5.17	62,182	5.09
21-25 years	2,347	17.29	220,429	17.35	2,426	17.86	231,232	18.13	2,239	16.99	213,477	17.48
More than 25 years	4,825	35.54	560,972	44.17	4,984	36.70	581,971	45.64	5,036	38.22	586,885	48.04
Total	13,576	100.00%	\$ 1,270,387	100.00%	13,580	100.00%	\$ 1,275,180	100.00%	13,179	100.00%	\$ 1,221,555	100.00%

**Lending Activities**

**General** A savings bank generally may not make loans to one borrower and related entities in an amount which exceeds 15% of its unimpaired capital and surplus, although loans in an amount equal to an additional 10% of unimpaired capital and surplus may be made to a borrower if the loans are fully secured by readily marketable collateral. Real estate is not considered readily marketable collateral. Certain types of loans are not subject to these limits. In applying these limits, loans to certain borrowers may be aggregated. Notwithstanding the specified limits, a savings bank may lend to one borrower up to \$500,000 for any purpose. At December 31, 2011, First Federal's limit on loans-to-one borrower was \$39.8 million and its five largest loans (including available lines of credit) or groups of loans to one borrower, including related entities, were \$28.1 million, \$20.9 million, \$19.4 million, \$19.2 million and \$16.5 million. All of these loans or groups of loans were performing in accordance with their terms at December 31, 2011.

**Loan Portfolio Composition** The net increase or (decrease) in net loans receivable over the prior year was (\$24.6 million), (\$102.2 million) and (\$12.1 million) in 2011, 2010, and 2009, respectively. The loan portfolio contains no foreign loans. The Company's loan portfolio is concentrated geographically in its northwest Ohio, northeast Indiana and southeast Michigan market areas. Management has identified lending for income generating rental properties as an industry concentration. Total loans for income generating property totaled \$373.6 million at December 31, 2011, which represents 26% of the Company's loan portfolio.

The following table sets forth the composition of the Company's loan portfolio by type of loan at the dates indicated.

**Table of Contents**

	2011		2010		December 31 2009		2008		2007	
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
<i>(Dollars in Thousands)</i>										
Real estate:										
Single family residential	\$ 203,401	13.6%	\$ 205,938	13.5%	\$ 227,592	13.8%	\$ 251,807	15.4%	\$ 231,921	17.9%
Five or more family residential	126,246	8.4	120,534	7.9	103,169	6.3	78,427	4.8	56,774	4.4
Nonresidential real estate	649,746	43.3	646,478	42.2	703,721	42.8	677,313	41.3	545,077	42.1
Construction	31,552	2.1	30,340	2.0	48,625	3.0	72,938	4.4	13,146	1.0
Total real estate loans	1,010,945	67.4	1,003,290	65.6	1,083,107	65.9	1,080,485	65.9	846,918	65.4
Other:										
Consumer finance	18,887	1.3	22,848	1.5	34,105	2.0	41,012	2.5	37,743	2.9
Commercial	349,053	23.2	369,959	24.2	379,408	23.1	356,574	21.8	283,072	21.8
Home equity and improvement	122,143	8.1	133,593	8.7	147,977	9.0	161,106	9.8	128,080	9.9
Total non-real estate loans	490,083	32.6	526,400	34.4	561,490	34.1	558,692	34.1	448,895	34.6
Total loans	1,501,028	100.0%	1,529,690	100.0%	1,644,597	100.0%	1,639,177	100.0%	1,295,813	100.0%
Less:										
Loans in process	13,243		9,267		26,494		20,892		5,085	
Deferred loan origination fees	709		920		981		1,050		1,032	
Allowance for loan losses	33,254		41,080		36,547		24,592		13,890	
Net loans	\$ 1,453,822		\$ 1,478,423		\$ 1,580,575		\$ 1,592,643		\$ 1,275,806	

In addition to the loans reported above, First Defiance had \$13.8 million, \$18.1 million, \$10.3 million, \$11.0 million, and \$5.8 million in loans classified as held for sale at December 31, 2011, 2010, 2009, 2008 and 2007, respectively. The fair value of such loans, which are all single-family residential mortgage loans, approximated their carrying value for all years presented.

**Contractual Principal, Repayments and Interest Rates** The following table sets forth certain information at December 31, 2011 regarding the dollar amount of gross loans maturing in First Defiance's portfolio, based on the contractual terms to maturity. Demand loans, loans having no stated schedule of repayments and no stated maturity, and overdrafts are reported as due in one year or less.

	Years After December 31, 2011						
	Due Less than 1	Due 1-2	Due 3-5	Due 5-10	Due 10-15	Due 15+	Total
<i>(In Thousands)</i>							
Real estate	\$ 270,985	\$ 228,118	\$ 373,555	\$ 69,335	\$ 22,610	\$ 46,342	\$ 1,010,945
Non-real estate:							
Commercial	241,586	47,505	55,541	4,418	3		349,053
Home equity and improvement	63,252	15,684	38,514	4,257	203	233	122,143

## Edgar Filing: FIRST DEFIANCE FINANCIAL CORP - Form 10-K

Consumer finance	9,132	4,881	4,532	301	35	6	18,887
Total	\$ 584,955	\$ 296,188	\$ 472,142	\$ 78,311	\$ 22,851	\$ 46,581	\$ 1,501,028

The schedule above does not reflect the actual life of the Company's loan portfolio. The average life of loans is substantially less than their contractual terms because of prepayments and due-on-sale clauses, which give First Defiance the right to declare a conventional loan immediately due and payable in the event, among other things, that the borrower sells the real property subject to the mortgage and the loan is not repaid.

**Table of Contents**

The following table sets forth the dollar amount of gross loans due after one year from December 31, 2011 which have fixed interest rates or which have floating or adjustable interest rates.

	Fixed Rates	Floating or Adjustable Rates (In Thousands)	Total
Real estate	\$ 270,821	\$ 469,139	\$ 739,960
Commercial	87,464	20,003	107,467
Other	67,302	1,344	68,646
	\$ 425,587	\$ 490,486	\$ 916,073

**Originations, Purchases and Sales of Loans** The lending activities of First Federal are subject to the written, non-discriminatory, underwriting standards and loan origination procedures established by the Board of Directors and management. Loan originations are obtained from a variety of sources, including referrals from existing customers, real estate brokers, developers and builders, newspaper and radio advertising and walk-in customers.

First Federal's loan approval process for all types of loans is intended to assess the borrower's ability to repay the loan, the viability of the loan and the adequacy of the value of the collateral that will secure the loan.

A commercial loan application is first reviewed and underwritten by one of the commercial loan officers, who may approve credits within their lending limit. Another loan officer with limits sufficient to cover the exposure must approve credits exceeding an individual's lending limit. All credits which exceed \$100,000 in aggregate exposure must be presented for review or approval to the Senior Loan Committee comprised of senior lending personnel. Credits which exceed \$1,000,000 in aggregate exposure must be presented for approval to the Executive Loan Committee, a committee of First Federal's Board of Directors.

Residential mortgage applications are accepted by retail lenders or branch managers, who utilize an automated underwriting system to review the loan request. First Federal also receives mortgage applications via an online residential mortgage origination system. A final approval of all residential mortgage applications is made by a member of a centralized underwriting staff within their designated lending limits. Loan requests in excess or outside an individual underwriter's limit are approved by the Senior Loan Committee and, if necessary, by the Executive Loan Committee.

Retail lenders and branch managers are authorized to originate and approve direct consumer loan requests that are within policy guidelines and within the lender's approved lending limit. Loans in excess of the lender's approved lending limit may be approved by retail lending managers up to their approved lending limit. Loans in excess of the retail lending manager's authorized lending limit or outside of policy must be approved by Senior Loan Committee and, if necessary, by the Executive Loan Committee. Indirect consumer loans originated by auto dealers are underwritten and approved by a designated underwriter in accordance with company policy and lending limits.

First Defiance offers adjustable-rate loans in order to decrease the vulnerability of its operations to changes in interest rates. The demand for adjustable-rate loans in First Defiance's primary market area has been a function of several factors, including customer preference, the level of interest rates, the

**Table of Contents**

expectations of changes in the level of interest rates and the difference between the interest rates offered for fixed-rate loans and adjustable-rate loans. The relative amount of fixed-rate and adjustable-rate residential loans that can be originated at any time is largely determined by the demand for each in a competitive environment.

Adjustable-rate loans represented 5.4% of First Defiance's total originations of one-to-four family residential mortgage loans in 2011 compared to 6.6% and 1.4% during 2010 and 2009, respectively.

Adjustable-rate loans decrease the risks associated with changes in interest rates, but involve other risks, primarily because as interest rates rise, the payment by the borrower rises to the extent permitted by the terms of the loan, thereby increasing the potential for default. At the same time, the marketability of the underlying property may be adversely affected by higher interest rates.

The following table shows total loans originated, loan reductions, and the net increase in First Defiance's total loans and loans held for sale during the periods indicated:

	Years Ended December 31		
	2011	2010	2009
	<i>(In Thousands)</i>		
Loan originations:			
Single family residential	\$ 282,321	\$ 420,644	\$ 572,500
Multi-family residential	11,401	44,173	75,632
Non-residential real estate	125,884	149,717	197,320
Construction	29,189	11,821	10,241
Commercial	186,338	290,501	341,477
Home equity and improvement	19,063	15,289	16,956
Consumer finance	10,216	12,230	16,530
Total loans originated	664,412	944,375	1,230,656
Loans Purchased:	25,842		
Loan reductions:			
Loan pay-offs	227,812	254,537	317,239
Loans sold	266,580	390,908	518,453
Periodic principal repayments	228,810	406,056	390,158
	723,202	1,051,501	1,225,850
Net (decrease) increase in total loans and loans held for sale	\$ (32,948)	\$ (107,126)	\$ 4,806

**Asset Quality**

First Defiance's credit policy establishes guidelines to manage credit risk and asset quality. These guidelines include loan review and early identification of problem loans to ensure sound credit decisions. First Defiance's credit policies and review procedures are meant to minimize the risk and uncertainties inherent in lending. In following the policies and procedures, management must rely on estimates, appraisals and evaluations of loans and the possibility that changes in these could occur because of changing economic conditions.

**Delinquent Loans** The following table sets forth information concerning delinquent loans at December 31, 2011, in dollar amount and as a percentage of First Defiance's total loan portfolio. The amounts presented represent the total outstanding principal balances of the related loans, rather than the actual payment amounts that are past due.

**Table of Contents**

	30 to 59 Days		60 to 89 Days		90 Days and Over and Non accrual		Total	
	Amount	Percentage	Amount	Percentage	Amount	Percentage	Amount	Percentage
	<i>(Dollars in Thousands)</i>							
Single family residential and construction	\$ 2,014	0.14%	\$ 106	0.01%	\$ 3,890	0.26%	\$ 6,010	0.41%
Nonresidential and Multi-family residential	2,489	0.17	952	0.06	28,150	1.90	31,591	2.13
Home equity and improvement	2,576	0.17	265	0.02	394	0.03	3,235	0.22
Consumer finance	129	0.01	35	0.00	10	0.00	174	0.01
Commercial	276	0.02	58	0.00	6,884	0.47	7,218	0.49
Total	\$ 7,484	0.51%	\$ 1,416	0.09%	\$ 39,328	2.66%	\$ 48,228	3.26%

Overall, the level of delinquencies at December 31, 2011 has decreased from the levels at December 31, 2010, when First Defiance reported that 3.41% of its outstanding loans were at least 30 days delinquent. The level of total loans 90 or more days delinquent has decreased to 2.66% at December 31, 2011 from 2.68% at December 31, 2010. The level of total loans 60-89 days delinquent has decreased to 0.09% at December 31, 2011 from 0.36% at December 31, 2010. Overall, the level of loans that were 30 to 59 days past due past due increased from 0.37% at December 31, 2010 to 0.51% at December 31, 2011. Management has assessed the collectability of all loans that are 90 days or more delinquent as part of its procedures in establishing the allowance for loan losses.

**Nonperforming Assets** All loans are reviewed on a regular basis and are placed on non-accrual status when, in the opinion of management, the collectability of additional interest is deemed insufficient to warrant further accrual. Generally, First Defiance places all loans more than 90 days past due on non-accrual status. First Defiance also places loans on non-accrual when the loan is paying as agreed but the Company believes the financial condition of the borrower is such that this classification is warranted. When a loan is placed on non-accrual status, total unpaid interest accrued to date is reversed. Subsequent payments are generally applied to the outstanding principal balance but may be recorded as interest income, depending on the assessment of the ultimate collectability of the loan. First Defiance considers that a loan is impaired when, based on current information and events, it is probable that it will be unable to collect all amounts due (both principal and interest) according to the contractual terms of the loan agreement. First Defiance measures impairment based on the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's observable market price, or the fair value of the collateral, if collateral dependent. If the estimated recoverability of the impaired loan is less than the recorded investment, First Defiance will recognize impairment by allocating a portion of the allowance for loan losses.

Impaired loans acquired in the ComBanc, Genoa and Pavilion acquisitions have been accounted for under the provisions of FASB ASC Topic 310 Subtopic 30, *Loans and Debt Securities Acquired with Deteriorated Credit Quality*. Such loans were recorded at their fair value, which was estimated based on the expected cash flow of the acquired loan. In the Genoa acquisition, 10 loan relationships with a stated value of \$1.5 million were recorded at \$721,000. In the ComBanc acquisition, 12 loan relationships with a stated value of \$3.4 million were recorded at \$2.0 million. In the Pavilion acquisition, 12 loan relationships with a stated value of \$6.4 million were recorded at \$4.4 million. Of all these impaired loans that were acquired in an acquisition, as of December 31, 2011, 11 loan relationships remained with

## **Table of Contents**

a contractual balance of \$2.2 million and were recorded at \$1.2 million. If management's expectations about the cash flow of those loans changes over time, the difference will be recognized as a yield adjustment over the remaining life of the respective loan. In 2011, \$33,000 of impairment was recognized as a yield adjustment. There were no significant changes in the expected cash flows of the remaining loan relationships in 2011.

Loans originated by First Federal having principal balances of \$47.9 million, \$70.9 million and \$58.8 million were considered impaired as of December 31, 2011, 2010 and 2009, respectively. These amounts exclude large groups of small-balance homogeneous loans that are collectively evaluated for impairment such as residential mortgage, consumer installment and credit card loans. There was \$1.6 million of interest received and recorded in income during 2011 related to impaired loans. There was \$2.0 million and \$913,000 recorded in 2010 and 2009, respectively. Unrecorded interest income based on the loan's contractual terms on these impaired loans and all non-performing loans in 2011, 2010 and 2009 was \$2.3 million, \$2.0 million, and \$2.7 million, respectively. The average recorded investment in impaired loans during 2011, 2010 and 2009 (excluding loans accounted for under Topic 310 Subtopic 30) was \$61.0 million, \$64.4 million and \$38.9 million, respectively. The total allowance for loan losses related to these loans was \$7.2 million, \$16.6 million, and \$12.2 million at December 31, 2011, 2010 and 2009, respectively.

Real estate acquired by foreclosure is classified as real estate owned until such time as it is sold. First Defiance also repossesses other assets securing loans, consisting primarily of automobiles. When such property is acquired it is recorded at fair value less cost to sell. Costs relating to development and improvement of property are capitalized, whereas costs relating to holding the property are expensed. Valuations are periodically performed by management and a write-down of the value is recorded with a corresponding charge to operations if it is determined that the carrying value of property exceeds its estimated net realizable value. During 2011, First Defiance recognized \$1.0 million of expense related to write-downs in value of real estate acquired by foreclosure. The balance of real estate owned at December 31, 2011 was \$3.6 million.

As of December 31, 2011, First Defiance's total non-performing loans amounted to \$42.7 million or 2.87% of total loans (net of undisbursed loan funds and deferred fees and costs), compared to \$47.0 million or 3.10% of total loans, at December 31, 2010. Non-performing loans are loans which are more than 90 days past due or on nonaccrual or loans which have been restructured and identified as troubled debt restructurings. The nonperforming loan balance includes \$32.4 million of loans originated by First Federal also considered impaired or acquired loans accounted for under Topic 310 Subtopic 30.

The following table sets forth the amounts and categories of First Defiance's non-performing assets (excluding impaired loans not considered non-performing) and troubled debt restructurings at the dates indicated.

**Table of Contents**

	2011	2010	December 31 2009	2008	2007
	<i>(Dollars in Thousands)</i>				
Nonperforming loans:					
Single family residential, construction and home improvement	\$ 4,284	\$ 7,742	\$ 6,475	\$ 5,088	\$ 2,608
Nonresidential and multi-family residential real estate	28,150	21,737	24,042	19,979	5,917
Commercial	6,884	11,547	10,615	2,881	675
Consumer finance	10	14	59	69	17
Troubled debt restructurings	3,380	6,001	6,715	6,250	
Total nonperforming loans	42,708	47,041	47,906	34,267	9,217
Real estate owned	3,608	9,591	13,413	6,973	2,410
Other repossessed assets	20		114	27	50
Total repossessed assets	3,628	9,591	13,527	7,000	2,460
Total nonperforming assets	\$ 46,336	\$ 56,632	\$ 61,433	\$ 41,267	\$ 11,677
Total nonperforming assets as a percentage of total assets	2.24%	2.78%	2.99%	2.11%	0.73%
Total nonperforming loans as a percentage of total loans*	2.87%	3.10%	2.96%	2.12%	0.71%
Allowance for loan losses as a percent of total nonperforming assets	71.77%	72.54%	59.49%	59.59%	118.95%

\* Total loans are net of undisbursed loan funds and deferred fees and costs.

In addition to the \$42.7 million of non-performing loans reported above and \$15.5 million of loans considered impaired (including loans accounted for under Topic 310 Subtopic 30), which are not included in the non-performing loans reported above, there are approximately \$67.9 million of performing nonresidential real estate and commercial loans where known information about possible credit problems of the borrowers causes management to have doubts as to the ability of such borrowers to comply with the present loan repayment terms and which may result in the inclusion of such loans in non-performing loans at some future date. In analyzing these loans for the purpose of determining the adequacy of the allowance for loan losses, management has determined that these loans generally have significant collateral, strong guarantors, or both.

**Allowance for Loan Losses** First Defiance maintains an allowance for loan losses to absorb probable incurred credit losses in the loan portfolio. The allowance for loan loss is made up of two components. The first is a general reserve, which is used to record loan loss reserves for groups of homogenous loans in which the Company estimates the losses incurred in the portfolio based on quantitative and qualitative factors. Quantitative factors are primarily the historical loss experience of the portfolio for the most recent weighted two years. Qualitative factors that may lead the Company to add additional general reserves on the non-impaired loan portfolio include such things as: changes in international, national and local economic business conditions, changes in the value of underlying collateral for collateral dependent loans, changes in the political and regulatory environment and changes in the trends of the loan portfolio.

The second component of the allowance for loan loss is the specific reserve in which the Company sets aside reserves based on the analysis of individual credits. In evaluating the adequacy of its allowance each quarter, management grades all loans in the commercial portfolio. In establishing specific reserves, the Company analyzes all substandard, doubtful and loss graded loans quarterly and makes



**Table of Contents**

judgments about the risk of loss based on the cash flow of the borrower, the value of any collateral and the financial strength of any guarantors. The Company also considers the impacts of any Small Business Association or Farm Service Agency guarantees. An internal loan review of all loan relationships between \$250,000 and \$750,000 is performed annually. Management also engages a third-party to do an annual review of all loan relationships in excess of \$750,000. Both of these loan reviews, among other things, independently assess management's loan grades.

Loans charged-off are charged against the allowance when such loans meet the Company's established policy on loan charge-offs and the allowance itself is adjusted quarterly by recording a provision for loan losses. As such, actual losses and losses provided for should be approximately the same if the overall quality, composition and size of the portfolio remained static. To the extent that the portfolio grows at a rapid rate or overall quality deteriorates, the provision generally will exceed charge-offs, as happened in 2008 through 2010. However, in certain circumstances, as happened in 2011, net charge-offs may exceed the provision for loan losses when management determines that loans previously provided for in the allowance for loan losses are uncollectible and should be charged off. Although management believes that it uses the best information available to make such determinations, future adjustments to the allowances may be necessary, and net earnings could be significantly affected, if circumstances differ substantially from the assumptions used in making the initial determinations.

At December 31, 2011, First Defiance's allowance for loan losses amounted to \$33.3 million compared to \$41.1 million at December 31, 2010. The following table sets forth the activity in First Defiance's allowance for loan losses during the periods indicated.

	Years Ended December 31				
	2011	2010	2009	2008	2007
	<i>(Dollars in Thousands)</i>				
Allowance at beginning of year	\$ 41,080	\$ 36,547	\$ 24,592	\$ 13,890	\$ 13,579
Provision for credit losses	12,434	23,177	23,232	12,585	2,306
Allowance acquired in acquisitions				4,258	
Charge-offs:					
Single family residential real estate	(2,753)	(3,092)	(2,281)	(1,185)	(256)
Commercial real estate	(13,150)	(9,928)	(5,799)	(3,758)	(1,803)
Commercial	(4,398)	(5,118)	(2,664)	(813)	(99)
Consumer finance	(95)	(124)	(320)	(380)	(161)
Home equity and improvement	(1,052)	(1,066)	(762)	(363)	(81)
Total charge-offs	(21,448)	(19,328)	(11,826)	(6,499)	(2,400)
Recoveries	1,188	684	549	358	405
Net charge-offs	(20,260)	(18,644)	(11,277)	(6,141)	(1,995)
Ending allowance	\$ 33,254	\$ 41,080	\$ 36,547	\$ 24,592	\$ 13,890
Allowance for loan losses to total non-performing loans at end of year	77.86%	87.33%	76.29%	71.77%	150.70%
Allowance for loan losses to total loans at end of year*	2.24%	2.70%	2.26%	1.52%	1.08%
Allowance for loan losses to net charge-offs for the year	164.14%	220.34%	324.08%	400.46%	696.24%
Net charge-offs for the year to average loans	1.41%	1.21%	0.70%	0.41%	0.16%

\* Total loans are net of undisbursed loan funds and deferred fees and costs.

**Table of Contents**

The provision for credit losses, as well as charge-offs, has increased significantly from 2008 through 2011 due mainly to continued deteriorating national and local economic conditions and the declining values of the underlying collateral of collateral dependent loans. The increase is due to some large relationships in the commercial real estate and commercial portfolios that were charged off due to the effect of the slowing economy. Management anticipates a lower level of net charge-offs in 2012 compared to 2011 and feels that the level of the allowance for loan losses at December 31, 2011 is sufficient to cover the estimated losses incurred but not yet recognized in the loan portfolio.

The following table sets forth information concerning the allocation of First Defiance's allowance for loan losses by loan categories at the dates indicated. For information about the percent of total loans in each category to total loans, see Lending Activities-Loan Portfolio Composition.

	2011		2010		December 31 2009		2008		2007	
	Amount	Percent of total loans by category	Amount	Percent of total loans by category	Amount	Percent of total loans by category	Amount	Percent of total loans by category	Amount	Percent of total loans by category
<i>(Dollars in Thousands)</i>										
Single family residential and construction	\$ 4,158	15.7%	\$ 6,029	15.5%	\$ 6,048	16.8%	\$ 3,678	19.8%	\$ 2,112	18.9%
Nonresidential and Multi-family residential real estate	20,490	51.7	22,355	50.1	18,876	49.1	13,436	46.1	7,750	46.5
Other:										
Commercial loans	6,576	23.2	10,871	24.2	9,444	23.1	6,351	21.8	3,420	21.8
Consumer and home equity and improvement loans	2,030	9.4	1,825	10.2	2,179	11.0	1,127	12.3	608	12.8
	\$ 33,254	100.0%	\$ 41,080	100.0%	\$ 36,547	100.0%	\$ 24,592	100.0%	\$ 13,890	100.0%

**Sources of Funds**

**General** Deposits are the primary source of First Defiance's funds for lending and other investment purposes. In addition to deposits, First Defiance derives funds from loan principal repayments. Loan repayments are a relatively stable source of funds, while deposit inflows and outflows are significantly influenced by general interest rates and money market conditions. Borrowings from the FHLB may be used on a short-term basis to compensate for reductions in the availability of funds from other sources. They may also be used on a longer-term basis for general business purposes. During 2007, First Defiance issued \$15.0 million of trust preferred securities through an unconsolidated affiliated trust. Proceeds from the offering were used for general corporate purposes including funding of dividends and stock buybacks as well as bolstering regulatory capital at the First Federal level. First Defiance also issued \$20.0 million of similar trust preferred securities in 2005.

**Deposits** First Defiance's deposits are attracted principally from within First Defiance's primary market area through the offering of a broad selection of deposit instruments, including checking accounts, money market accounts, regular savings accounts, and term certificate accounts. Deposit account terms vary, with the principal differences being the minimum balance required, the time periods the funds must remain on deposit, and the interest rate.

To supplement its funding needs, First Defiance also utilizes the national market for Certificates of Deposit. Such deposits have maturities ranging from one to thirty-five months. These deposits are issued at the current rates available to customers in our market areas. The total balance of national certificates of deposit was \$10.6 million and \$41.8 million at December 31, 2011 and 2010, respectively.

**Table of Contents**

Average balances and average rates paid on deposits are as follows:

	2011		Years Ended December 31		2009	
	Amount	Rate	Amount	Rate	Amount	Rate
	<i>(Dollars in Thousands)</i>					
Non-interest-bearing demand deposits	\$ 231,343		\$ 200,864		\$ 176,513	
Interest bearing demand deposits	592,093	0.36%	529,078	0.59%	447,858	0.77%
Savings deposits	153,318	0.16	139,049	0.26	132,589	0.35
Time deposits	613,374	1.60	721,203	2.18	790,379	2.81
Totals	\$ 1,590,128	0.77%	\$ 1,590,194	1.21%	\$ 1,547,339	1.69%

The following table sets forth the maturities of First Defiance's retail certificates of deposit having principal amounts of \$100,000 or more at December 31, 2011 (in thousands):

Retail certificates of deposit maturing in quarter ending:

March 31, 2011	\$ 35,193
June 30, 2011	22,636
September 30, 2011	25,681
December 31, 2011	17,807
After December 31, 2011	86,596

Total retail certificates of deposit with balances of \$100,000 or more \$ 187,913

The following table details the deposit accrued interest payable as of December 31:

	2011	2010
	<i>(In Thousands)</i>	
Interest bearing demand deposits and money market accounts	\$ 26	\$ 40
Certificates of deposit	92	211
	\$ 118	\$ 251

For additional information regarding First Defiance's deposits see Note 12 to the financial statements.

**Borrowings** First Defiance may obtain advances from the FHLB of Cincinnati by pledging certain of its residential mortgage loans, non-residential loans, multi-family loans, home equity loans and investment securities provided certain standards related to creditworthiness have been met. Such advances are made pursuant to several credit programs, each of which has its own interest rate and range of maturities.

The following table sets forth certain information as to First Defiance's FHLB advances and other borrowings at the dates indicated.

**Table of Contents**

	2011	December 31 2010 (Dollars in Thousands)	2009
Long-term:			
FHLB advances	\$ 81,841	\$ 116,885	\$ 146,927
Weighted average interest rate	3.66%	3.68%	3.36%
Short-term:			
FHLB advances	\$	\$	\$
Weighted average interest rate			
Securities sold under agreement to repurchase	\$ 60,386	\$ 56,247	\$ 48,398
Weighted average interest rate	0.92%	0.98%	1.05%

The following table sets forth the maximum month-end balance and average balance of First Defiance's long-term FHLB advances and other borrowings during the periods indicated.

	2011	Years Ended December 31 2010 (Dollars in Thousands)	2009
Long-term:			
FHLB advances:			
Maximum balance	\$ 116,882	\$ 146,927	\$ 146,967
Average balance	93,652	127,281	146,946
Weighted average interest rate	3.43%	3.70%	3.48%

The following table sets forth the maximum month-end balance and average balance of First Defiance's short-term FHLB advances and other borrowings during the periods indicated.

	2011	Years Ended December 31 2010 (Dollars in Thousands)	2009
Short-term:			
FHLB advances:			
Maximum balance	\$	\$	\$
Average balance	16		33
Weighted average interest rate	0.17%		0.84%
Revolving credit agreements:			
Maximum balance	\$	\$	\$
Average balance			
Weighted average interest rate			
Securities sold under agreement to repurchase:			
Maximum balance	\$ 61,240	\$ 56,247	\$ 50,920
Average balance	56,495	47,088	44,287
Weighted average interest rate	0.94%	0.97%	1.29%

First Defiance borrows funds under a variety of programs at the FHLB. As of December 31, 2011, there was \$81.8 million outstanding under various long-term FHLB advance programs. First Defiance utilizes short-term advances from the FHLB to meet cash flow needs and for short-term

## **Table of Contents**

investment purposes. At December 31, 2011 and December 31, 2010, no outstanding balances existed under First Defiance's Cash Management Advance Line of Credit. The total available under this line is \$15.0 million. Additionally, First Defiance has \$100.0 million available under a REPO line of credit. Amounts are generally borrowed under these lines on an overnight basis. First Federal's total borrowing capacity at the FHLB is limited by various collateral requirements. Eligible collateral includes mortgage loans, home equity loans, non-mortgage loans, cash, and investment securities. At December 31, 2011, other than amounts available on the REPO and Cash Management line, First Federal had additional borrowing capacity with the FHLB of \$147.9 million as a result of these collateral requirements.

As a member of the FHLB of Cincinnati, First Federal must maintain a minimum investment in the capital stock of that FHLB in an amount defined in the FHLB's regulations. First Federal is permitted to own stock in excess of the minimum requirement and is in compliance with the minimum requirement with an investment in stock of the FHLB of Cincinnati of \$19.3 million at December 31, 2011. First Federal also acquired \$2.0 million in stock of the FHLB of Indianapolis from the Pavilion acquisition, which had a balance of \$1.3 million at December 31, 2011. This stock is required to be held for a minimum of five years from the date the stock was acquired by First Federal, March 14, 2008.

Each FHLB is required to establish standards of community investment or service that its members must maintain for continued access to long-term advances from the FHLB. The standards take into account a member's performance under the Community Reinvestment Act and its record of lending to first-time homebuyers.

For additional information regarding First Defiance's FHLB advances and other debt see Notes 13 and 15 to the financial statements.

***Subordinated Debentures*** In March 2007, the Company sponsored an affiliated trust, First Defiance Statutory Trust II (Trust Affiliate II) that issued \$15 million of Guaranteed Capital Trust Securities (Trust Preferred Securities). In connection with the transaction, the Company issued \$15.5 million of Junior Subordinated Deferrable Interest Debentures (Subordinated Debentures) to Trust Affiliate II. Trust Affiliate II was formed for the purpose of issuing Trust Preferred Securities to third-party investors and investing the proceeds from the sale of these capital securities solely in Subordinated Debentures of the Company. The Subordinated Debentures held by Trust Affiliate II are the sole assets of the trust. Distributions on the Trust Preferred Securities issued by Trust Affiliate II are payable quarterly at a fixed rate equal to 6.441% for the first five years and a floating rate of three-month LIBOR plus 1.50%, repricing quarterly, thereafter.

The Trust Preferred Securities are subject to mandatory redemption, in whole or in part, upon repayment of the Subordinated Debentures. The Company has entered into an agreement that fully and unconditionally guarantees the Trust Preferred Securities subject to the terms of the guarantee. The Trust Preferred Securities and Subordinated Debentures mature on June 15, 2037, but may be redeemed at the Company's option at any time on or after June 15, 2012, or at any time upon certain events.

In October 2005, the Company formed an affiliated trust, First Defiance Statutory Trust I (Trust Affiliate I) that issued \$20 million of Trust Preferred Securities. In connection with the transaction, the Company issued \$20.6 million of Subordinated Debentures to Trust Affiliate I. Trust Affiliate I was formed for the purpose of issuing Trust Preferred Securities to third-party investors and investing the proceeds from the sale of these capital securities solely in Subordinated Debentures of the Company. The Subordinated Debentures held by Trust Affiliate I are the sole assets of the trust. Distributions on the Trust Preferred Securities issued by Trust Affiliate I are payable quarterly at a variable rate equal to the three-month LIBOR rate plus 1.38%, or 1.73% as of December 31, 2011. The rate was 1.67% at December 31, 2010.

## **Table of Contents**

The Trust Preferred Securities issued by Trust Affiliate I are subject to mandatory redemption, in whole or in part, upon repayment of the Subordinated Debentures. The Company has entered into an agreement that fully and unconditionally guarantees the Trust Preferred Securities subject to the terms of the guarantee. The Trust Preferred Securities and Subordinated Debentures may be redeemed by the issuer at par after October 28, 2010. The Subordinated Debentures mature on December 15, 2035.

Due to the Company's participation in the U.S. Treasury's Capital Purchase Program, permission must be obtained from the U.S. Treasury in order to call these securities.

### **Participation in the Capital Purchase Program**

In December 2008, First Defiance participated in the U.S. Treasury's Capital Purchase Program (CPP). Under the CPP, First Defiance issued \$37.0 million of First Defiance non-voting preferred stock and a warrant to purchase 550,595 shares of First Defiance's common stock at an exercise price of \$10.08 per share, subject to certain anti-dilution and other adjustments. The \$37.0 million of preferred stock issued by First Defiance under the CPP qualifies as Tier 1 capital. The cash received from the preferred stock issuance is reflected in the financing activities section of the Consolidated Statements of Cash Flows in Item 8 of this Form 10-K. The general purpose of the funds was to maintain and create lending opportunities in our market area.

### **Employees**

First Defiance had 581 employees at December 31, 2011. None of these employees are represented by a collective bargaining agent, and First Defiance believes that it maintains good relationships with its personnel.

### **Competition**

Competition in originating non-residential mortgage and commercial loans comes mainly from commercial banks with banking center offices in the Company's market area. Competition for the origination of mortgage loans arises mainly from savings associations, commercial banks, and mortgage companies. The distinction among market participants is based on a combination of price, the quality of customer service and name recognition. The Company competes for loans by offering competitive interest rates and product types and by seeking to provide a higher level of personal service to borrowers than is furnished by competitors. First Federal has a significant market share of the lending markets in which it conducts operations.

Management believes that First Federal's most direct competition for deposits comes from local financial institutions. The distinction among market participants is based on price and the quality of customer service and name recognition. First Federal's cost of funds fluctuates with general market interest rates. During certain interest rate environments, additional significant competition for deposits may be expected from corporate and governmental debt securities, as well as from money market mutual funds. First Federal competes for conventional deposits by emphasizing quality of service, extensive product lines and competitive pricing.

**Table of Contents****Regulation**

**General** Provisions of The Dodd-Frank Wall Street Reform and Consumer Protections Act (the Dodd-Frank Act ) required the transfer of Office of Thrift Supervision functions to the Office of the Comptroller of the Currency ( OCC ), the FDIC, the Federal Reserve Board ( Federal Reserve ) and the Bureau of Consumer Financial Protection on July 21, 2011. As a result, First Defiance and First Federal are subject to regulation, examination and oversight by the Federal Reserve and the OCC, respectively. Because the FDIC insures First Federal's deposits, First Federal is also subject to examination and regulation by the FDIC. First Defiance and First Federal must file periodic reports with the Federal Reserve and the OCC and examinations are conducted periodically by the Federal Reserve, OCC and the FDIC to determine whether First Defiance and First Federal are in compliance with various regulatory requirements and are operating in a safe and sound manner. First Federal is subject to various consumer protection and fair lending laws. These laws govern, among other things, truth-in-lending disclosure, equal credit opportunity, and, in the case of First Federal, fair credit reporting and community reinvestment. Failure to abide by federal laws and regulations governing community reinvestment could limit the ability of First Federal to open a new branch or engage in a merger transaction. Community reinvestment regulations evaluate how well and to what extent First Federal lends and invests in its designated service area, with particular emphasis on low-to-moderate income communities and borrowers in such areas.

First Defiance is also subject to various Ohio laws which restrict takeover bids, tender offers and control-share acquisitions involving public companies which have significant ties to Ohio.

**Regulatory Capital Requirements** First Federal Bank is required by regulations to meet certain minimum capital requirements. Current capital requirements call for core capital of 4.0% of adjusted total assets, except for associations with the highest examination rating and acceptable levels of risk, and risk-based capital of 8.0% of risk-weighted assets.

The following table sets forth the amount and percentage level of regulatory capital of First Federal Bank at December 31, 2011, and the amount by which it exceeds the minimum capital requirements. Tier 1 capital is reflected as a percentage of adjusted total assets. Tier 1 capital to risk-weighted assets and total (or risk-based) capital, which consists of core and supplementary capital, is reflected as a percentage of risk-weighted assets. Assets are weighted at percentage levels ranging from 0% to 100% depending on their relative risk.

	Actual		Minimum Required for Adequately Capitalized		Minimum Required for Well Capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
<b><u>Tier 1 Capital (1)</u></b>						
First Federal Bank	\$ 231,787	11.62%	\$ 79,757	4.0%	\$ 99,697	5.0%
<b><u>Tier 1 Capital (to Risk Weighted Assets) (1)</u></b>						
First Federal Bank	\$ 231,787	14.16%	\$ 65,492	4.0%	\$ 98,238	6.0%
<b><u>Total Capital (to Risk Weighted Assets) (1)</u></b>						
First Federal Bank	\$ 252,411	15.42%	\$ 130,984	8.0%	\$ 163,730	10.0%

- (1) Core capital is computed as a percentage of adjusted total assets of \$1.99 billion for the Bank. Risk-based capital is computed as a percentage of total risk-weighted assets of \$1.64 billion for the Bank.

## **Table of Contents**

To be categorized as a well-capitalized institution, institutions need to maintain a tier 1 (core) capital ratio of 5%, a tier 1 capital to risk-weighted assets ratio of 6%, and a risk-based capital ratio of 10%. First Federal Bank's capital at December 31, 2011 meets the standards for a well-capitalized institution. There are no conditions or events since the most recent notification from any of the regulatory agencies regarding those capital standards that management believes have changed any of the well-capitalized categorizations of First Federal Bank.

**Dividends** First Defiance's payment of dividends to its shareholders is generally funded by the payment of dividends by the Subsidiaries. Dividends paid by First Federal to First Defiance are subject to various regulatory restrictions. First Federal can initiate dividend payments equal to its net profits (as defined by statute) for the current year plus the preceding two calendar years. First Federal is required to receive prior approval from its primary regulator, the OCC, before it can pay any dividends to First Defiance, its parent company. First Federal did not pay any dividends in 2011 and 2010. As a result of its participation in the CPP, First Defiance is prohibited, without prior approval from the U.S. Treasury, from paying a quarterly cash dividend of more than \$0.26 per share until the U.S. Treasury's preferred stock is redeemed or transferred to an unaffiliated third party.

**Transactions with Insiders and Affiliates** Loans to executive officers, directors and principal shareholders and their related interests must conform to the lending limits. Most loans to directors, executive officers and principal shareholders must be approved in advance by a majority of the disinterested members of board of directors of the association with any interested director not participating. All loans to directors, executive officers and principal shareholders must be made on terms substantially the same as offered in comparable transactions with the general public or as offered to all employees in a company-wide benefit program. Loans to executive officers are subject to additional restrictions. In addition, all related party transactions must be approved by the Company's audit committee pursuant to NASDAQ Rule 5630, including loans made by financial institutions in the ordinary course of business. All transactions between savings associations and their affiliates must comport with Sections 23A and 23B of the Federal Reserve Act (FRA) and the Federal Reserve Board's (FRB) Regulation W. An affiliate of a savings association is any company or entity that controls, is controlled by or is under common control with the savings association. First Defiance and First Insurance are affiliates of First Federal.

**Holding Company Regulation** First Defiance is a unitary thrift holding company and is subject to the Federal Reserve regulations, examination, supervision and reporting requirements. Federal law generally prohibits a thrift holding company from controlling any other savings association or thrift holding company, without prior approval of the Federal Reserve, or from acquiring or retaining more than 5% of the voting shares of a savings association or holding company thereof, which is not a subsidiary.

**Deposit Insurance** First Federal is a member of the Deposit Insurance Fund (DIF), which is administered by the FDIC. Deposit accounts at First Federal are insured by the FDIC, generally up to a maximum of \$250,000. Further, from December 31, 2010 through December 31, 2012, deposits held in noninterest-bearing transaction accounts will be fully insured by the FDIC regardless of the amount in the account. The Bank has opted to participate in the FDIC's Transaction Account Guarantee Program. See Temporary Liquidity Guarantee Program below.

During 2008, there were higher levels of bank failures which dramatically increased resolution costs of the FDIC and depleted the DIF. In order to maintain a strong funding position and restore reserve ratios of the DIF, on December 16, 2008, the FDIC issued a final rule that raised the then current



## Table of Contents

assessment rates of insured institutions uniformly by 7 basis points (7 cents for every \$100 of deposits), beginning with the first quarter of 2009. Further, beginning April 1, 2009, the FDIC required higher risk institutions to pay a larger share of premiums by factoring in rate adjustments based on secured liabilities and unsecured debt levels. On May 22, 2009, the FDIC issued a final rule that imposed a special assessment for the second quarter of 2009 of 5 basis points on each insured depository institution's assets minus its Tier 1 capital as of June 30, 2009, which was collected on September 30, 2009 in the amount of \$906,000 for First Federal. On November 12, 2009, the FDIC issued a final rule requiring insured depository institutions to prepay their estimated quarterly risk-based assessments for the fourth quarter of 2009 and for all of 2010, 2011 and 2012. The prepaid assessments for these periods were collected on December 30, 2009, along with the regular quarterly risk-based deposit insurance assessment for the third quarter of 2009. For the fourth quarter of 2009 and for all of 2010, the prepaid assessment rate was based on each institution's total base assessment rate in effect on September 30, 2009, modified to assume that the assessment rate in effect for the institution on September 30, 2009, was in effect for the entire third quarter of 2009. As of December 31, 2011, \$2.4 million in prepaid deposit insurance assessments is included in other assets in the accompanying consolidated balance sheet.

In October 2010, the FDIC adopted a new DIF restoration plan to ensure that the fund reserve ratio reaches 1.35% by September 30, 2020, as required by the Dodd-Frank Act. Under the new restoration plan, the FDIC will maintain the current schedule of assessment rates for all depository institutions. At least semi-annually, the FDIC will update its loss and income projections for the fund and, if needed, will increase or decrease assessment rates, following notice-and-comment rulemaking if required.

Insurance of deposits may be terminated by the FDIC upon finding that an institution has engaged in unsafe or unsound practices, is in an unsafe or unsound condition to continue operations or has violated any applicable law, regulation, rule, order or condition imposed by the FDIC. Management does not currently know of any practice, condition or violation that might lead to termination of the deposit insurance.

**Temporary Liquidity Guarantee Program** On October 14, 2008, the FDIC announced a new program, the Temporary Liquidity Guarantee Program. This program has two components – The Debt Guarantee Program and the Transaction Account Guarantee Program. The Debt Guarantee Program guarantees newly issued senior unsecured debt of a participating organization, up to certain limits established for each institution, issued between October 14, 2008 and June 30, 2009. The FDIC will pay the unpaid principal and interest on an FDIC-guaranteed debt instrument upon the uncured failure of the participating entity to make a timely payment of principal or interest in accordance with the terms of the instrument. The guarantee will remain in effect until June 30, 2012. In return for the FDIC's guarantee, participating institutions will pay the FDIC a fee based on the amount and maturity of the debt. The Company opted to participate in the Debt Guarantee Program.

The Transaction Account Guarantee Program provides full deposit insurance coverage for non-interest bearing transaction deposit accounts, regardless of dollar amount, until December 31, 2012, which was extended twice from December 31, 2009 and June 30, 2010, respectively. An annualized 25 basis point assessment (increased from 10 basis points) on balances in noninterest-bearing transaction accounts that exceed the existing deposit insurance limit of \$250,000 will be assessed on a quarterly basis to insured depository institutions that have not opted out of this component of the Temporary Liquidity Guarantee Program. The Company has opted to participate in the Transaction Account Guarantee Program.

---

## **Table of Contents**

### **Item 1A. Risk Factors**

An investment in the Company's common stock is subject to risks inherent to the Company's business. The material risks and uncertainties that management believes affect the Company are described below. Before making an investment decision, you should carefully consider the risks and uncertainties described below together with all of the other information included or incorporated by reference in this report. The risks and uncertainties described below are not the only ones facing the Company. Additional risks and uncertainties that management is not aware of or focused on or that management currently deems immaterial may also impair the Company's business operations.

If any of the following risks actually occur, the Company's financial condition and results of operations could be materially and adversely affected. If this were to happen, the market price of the Company's common stock could decline significantly, and you could lose all or part of your investment.

#### **Economic conditions may adversely affect First Defiance's operations and financial condition.**

**Local Economic Conditions** First Defiance conducts its banking and insurance business primarily in northwest Ohio, northeast Indiana and southeast Michigan. Unemployment rates for most of the counties within our geographic market area are above the median rate for the United States and above the median rates for the States of Ohio, Indiana, and Michigan. As reported for December 2011, the 14 counties in which our offices are located had unemployment rates between 7.2% and 13.3%, and all experienced an improvement in their unemployment rate in 2011 compared to 2010. In addition, real estate values in First Defiance's markets have declined and may continue to decline. High unemployment and declining real estate values have a negative impact on the Company's earnings and financial condition because:

more borrowers are unable to make payments on their loans;

the value of collateral securing loans has declined; and

the overall quality of the loan portfolio has declined.

**General Economic Conditions** Dramatic declines in real estate values, along with high unemployment, have disrupted the national credit and capital markets over the last several years. As a result, many financial institutions have had to seek additional capital, to merge with larger and stronger institutions, to seek government assistance or bankruptcy protection and, in some cases; they have been forced into a sale or closed by the bank regulatory agencies. Many lenders and institutional investors have reduced and, in some cases, ceased to provide funding to borrowers, including to other financial institutions, because of concern about the stability of the financial markets and the strength of counterparties. It is difficult to predict how long these economic conditions will exist, which of our markets, products or other businesses will ultimately be affected, and whether management's actions will effectively mitigate these external factors. The reduced availability of credit, the lack of confidence in the financial sector, decreased consumer confidence, increased volatility in the financial markets and reduced business activity could materially and adversely affect our business, financial condition and results of operations.

As a result of the challenges presented by economic conditions, First Defiance faces the following risks:

inability of borrowers to make timely repayments of their loans, or decreases in value of real estate collateral securing the payment of such loans resulting in significant credit losses, which could result in increased delinquencies, foreclosures and customer bankruptcies, any of which could have a material adverse effect on our operating results;

## **Table of Contents**

increased regulation of the financial services industry, including heightened legal standards and regulatory requirements or expectations; compliance with such regulation will likely increase costs and may limit the Company's ability to pursue business opportunities;

further disruptions in the capital markets or other events, including actions by rating agencies and deteriorating investor expectations, may result in an inability to borrow on favorable terms or at all from other financial institutions;

increased competition among financial services companies due to the consolidation of financial institutions, which may adversely affect our ability to market the Company's products and services; and

further increases in FDIC insurance premiums due to the market developments which have significantly depleted the insurance fund of the FDIC and reduced the ratio of reserves to insured deposits.

**Declining Real Estate Values** Approximately 75.5% of the loans in First Federal's portfolio are secured in whole or in part by real estate. As residential real estate prices have declined in the last three years, defaults and foreclosures have increased. Commercial real estate values have also declined, and the owners of many income-producing properties are experiencing declines in their revenue, which may adversely affect their ability to repay their loans. Foreclosures and resolutions of nonperforming loans require significant personnel resources and involve other costs that may increase our operating expenses. Properties acquired through foreclosure or by deed in lieu of foreclosure are taking longer to sell in the current economy, which increases the Company's expenses for managing, maintaining and insuring real estate owned. If First Federal is unable to sell properties at a price that will cover its expenses as well as the unpaid principal and interest on the loan, the resulting write-downs and losses will adversely affect First Defiance's net income.

**Volatile Capital Markets** The capital and credit markets have been experiencing volatility and disruption for more than a year. In some cases, the markets have produced downward pressure on credit availability for certain issuers. Continuing market disruption and volatility could have an adverse effect on the Company's ability to access capital and on its business, financial condition and results of operations.

First Defiance's stock price may fluctuate significantly in the future and these fluctuations may be unrelated to the underlying performance of First Defiance. General market price declines and overall market volatility in the future could adversely affect the price of its common stock, and the current market price of the stock may not be indicative of future market prices.

First Defiance's stock price has been volatile in the past and several factors could cause the price to fluctuate substantially in the future. These factors include:

Actions by government regulators;

First Defiance's announcements of developments related to its business;

Fluctuation in our results of operation;

Sales of substantial amounts of our securities into the marketplace;

New reports of trends, concerns and other issues related to the financial services industry.

## **Table of Contents**

**First Defiance's loan portfolio includes a concentration of commercial real estate loans and commercial loans, which involve risks specific to real estate value and the successful operations of these businesses.**

At December 31, 2011, First Federal's portfolio of commercial real estate loans totaled \$776.0 million, or approximately 51.7% of total loans. First Federal's commercial real estate loans typically have higher principal amounts than residential real estate loans, and many of our commercial real estate borrowers have more than one loan outstanding. As a result, an adverse development on one loan can expose First Defiance to greater risk of loss on other loans. Additionally, repayment of the loans is generally dependent, in large part, on sufficient income from the properties securing the loans to cover operating expenses and debt service. Economic conditions and events outside of the control of the borrower or lender could negatively impact the future cash flow and market values of the affected properties.

At December 31, 2011, First Federal's portfolio of commercial loans totaled \$349.1 million, or approximately 23.2% of total loans. Commercial loans generally expose First Defiance to a greater risk of nonpayment and loss than commercial real estate or residential real estate loans since repayment of such loans often depends on the successful operations and income stream of the borrowers. First Federal's commercial loans are primarily made based on the identified cash flow of the borrower and secondarily on the underlying collateral provided by the borrower such as accounts receivable, inventory, machinery or real estate. In the case of loans secured by accounts receivable, the availability of funds for the repayment of these loans may be substantially dependent on the ability of the borrower to collect amounts due from its customers. The collateral securing other loans may depreciate over time, may be difficult to appraise and may fluctuate in value based on the success of the business. Credit support provided by the borrower for most of these loans and the probability of repayment is based on the liquidation of the pledged collateral and enforcement of a personal guarantee, if any exists.

First Defiance targets its business lending towards small and medium-sized businesses, many of which have fewer financial resources than larger companies and may be more susceptible to economic downturns. If general economic conditions negatively impact these businesses, First Defiance's results of operations and financial condition may be adversely affected.

**Increases to the allowance for loan losses may cause First Defiance's earnings to decrease.**

First Defiance makes a number of assumptions and judgments about the collectability of its loan portfolio, including the creditworthiness of our borrowers and the value of the real estate and other assets serving as collateral for the repayment of loans. In determining the amount of the allowance for loan losses, First Defiance relies on loan quality reviews, past loss experience, and an evaluation of economic conditions, among other factors. If its assumptions prove to be incorrect, First Defiance's allowance for loan losses may not be sufficient to cover actual losses, resulting in additions to the allowance. Material additions to the allowance and any loan losses that exceed First Defiance's reserves would materially adversely affect our results of operations and financial condition.

**Changes in interest rates can adversely affect First Defiance's profitability**

First Defiance's earnings and financial condition are dependent to a large degree upon net interest income, which is the difference, or spread, between interest earned from loans and investments and interest paid on deposits and borrowings. Interest rates are highly sensitive to many factors, including:

## **Table of Contents**

the rate of inflation;

economic conditions;

federal monetary policies; and

stability of domestic and foreign markets.

Because First Defiance's interest-bearing liabilities may reprice or mature more quickly than its interest-earning assets, an increase in interest rates could result in a decrease in First Defiance's net interest income.

First Federal originates a significant amount of residential mortgage loans that it sells in the secondary market. The origination of residential mortgage loans is highly dependent on the local real estate market and the current interest rates. Increasing interest rates tend to reduce the origination of loans for sale and consequently fee income, which First Defiance reports as mortgage banking income. Conversely, decreasing interest rates have the effect of causing clients to refinance mortgage loans faster than anticipated. This causes the value of mortgage servicing rights on the loans sold to be lower than originally anticipated. If this happens, First Defiance may be required to write down the value of its mortgage servicing rights faster than anticipated, which will increase expense and lower earnings. Accelerated repayments on loans and mortgage backed securities could result in the reinvestment of funds at lower rates than the loans or securities were paying.

### **Laws and regulations may affect First Defiance's results of operations.**

The earnings of financial institutions are affected by the regulations and policies of various regulatory authorities, including the Federal Reserve Board, which regulates the money supply, and the Federal Reserve which regulates the Company and OCC which regulates First Federal, and the FDIC, which regulates First Federal. The Federal Reserve has extensive supervisory authority over the Company, affecting a comprehensive range of matters relating to ownership and control of First Defiance's shares, First Defiance's acquisition of other companies and businesses, permissible activities for the Company to engage in, maintenance of adequate capital levels and other aspects of operations. These supervisory and regulatory powers are intended primarily for the protection for First Defiance's depositors and customers and the deposit insurance fund, rather than First Defiance's shareholders.

In connection with its supervision of First Defiance, its former primary regulator, the Office of Thrift Supervision (OTS), which was eliminated and replaced by the Federal Reserve, and the Company entered into a memorandum of understanding (MOU), which is a tool employed by bank regulatory agencies to address areas of concern to the regulator. The memorandum for the Company requires that it submit to the Federal Reserve specific strategies for increasing and maintaining capital at targets, to be established by First Defiance's board of directors that are commensurate with First Defiance's risk profile. At December 31, 2011, The Company and First Federal's capital ratios exceed all the regulatory thresholds to be considered well-capitalized. The memorandum also requires that First Defiance obtain approval from the Federal Reserve before it pays any dividends, including dividends on common shares, or incur, issue, renew, or rollover any debt. First Federal also agreed to a memorandum of understanding with the OTS, which was eliminated and replaced by the OCC, the principal terms of which relate to First Federal's risk profile and asset quality. Compliance with the First Federal memorandum may restrict First Defiance's operations and adversely affect its financial results.

---

**Table of Contents**

First Defiance issued \$37.0 million of our Series A Preferred Shares to the U.S. Treasury pursuant to the CPP. The rules and policies applicable to CPP participants continue to evolve and their scope, timing and effect cannot be predicted. Current restrictions include limits on First Defiance's ability to pay retention awards, bonuses and other incentive compensation during the period in which it has any outstanding securities held by the U.S. Treasury that were issued under the CPP. These limitations may adversely affect First Defiance's ability to recruit and retain key personnel, especially if it is competing for talent against institutions that are not subject to the same restrictions.

The laws and regulations applicable to the banking industry could change at any time. As a result of ongoing challenges facing the U.S. economy in particular, the potential exists for new laws and regulations, and bank regulatory agencies are expected to be active in responding to concerns and trends identified in examinations. Increased regulation could increase First Defiance's cost of compliance and reduce its income to the extent that they limit the manner in which First Defiance may conduct business, including its ability to offer new products, charge fees for specific products and services, obtain financing, attract deposits, make loans and achieve satisfactory interest spreads.

**First Defiance's ability to meet cash flow needs on a timely basis at a reasonable cost may adversely affect net income.**

First Defiance's principal sources of liquidity are local deposits and wholesale funding sources such as FHLB advances, Federal Funds purchased, securities sold under repurchase agreements, and brokered or other out-of-market certificate of deposit purchases. Also, First Defiance maintains a portfolio of securities that can be used as a secondary source of liquidity. First Defiance's access to funding sources in amounts adequate to finance or capitalize its activities or on terms that are acceptable could be impaired by factors that affect First Defiance directly or the financial services industry or economy in general, such as further disruptions in the financial markets or negative views and expectations about the prospects for the financial services industry.

Other possible sources of liquidity include the sale or securitization of loans, the issuance of additional collateralized borrowings beyond those currently utilized with the FHLB, the issuance of debt securities and the issuance of preferred or common securities in public or private transactions, or borrowings from a commercial bank. First Defiance does not currently have any borrowings from a commercial bank, but it has used them in the past. Pursuant to the MOU, First Defiance must obtain Federal Reserve approval before incurring or issuing any debt.

Any decline in available funding could adversely impact our ability to originate loans, invest in securities, meet our expenses, pay dividends to First Defiance's shareholders, or fulfill obligations such as repaying First Defiance's borrowings or meeting deposit withdrawal demands, any of which could have a material adverse impact on our liquidity, business, results of operations and financial condition.

**Competition affects First Defiance's earnings.**

First Defiance's continued profitability depends on its ability to continue to effectively compete to originate loans and attract and retain deposits. Competition for both loans and deposits is intense in the financial services industry. The Company competes in its market area by offering superior service and competitive rates and products. The type of institutions First Defiance competes with include large regional commercial banks, smaller community banks, savings institutions, mortgage banking firms, credit unions, finance companies, brokerage firms, insurance agencies and mutual funds. As a result of their size and ability to achieve economies of scale, certain of First Defiance's competitors can offer a

## **Table of Contents**

broader range of products and services than the Company can offer. To stay competitive in its market area, First Defiance may need to adjust the interest rates on its products to match rates of its competition, which could have a negative impact on net interest margin.

### **The increasing complexity of First Defiance's operations presents varied risks that could affect its earnings and financial condition**

First Defiance processes a large volume of transactions on a daily basis and is exposed to numerous types of risks related to internal processes, people and systems. These risks include, but are not limited to, the risk of fraud by persons inside or outside the Company, the execution of unauthorized transactions by employees, errors relating to transaction processing and systems, breaches of data security and our internal control system and compliance with a complex array of consumer and safety and soundness regulations. First Defiance could also experience additional loss as a result of potential legal actions that could arise as a result of operational deficiencies or as a result of noncompliance with applicable laws and regulations.

First Defiance has established and maintains a system of internal controls that provides management with information on a timely basis and allows for the monitoring of compliance with operational standards. These systems have been designed to manage operational risks at an appropriate, cost effective level. Procedures exist that are designed to ensure that policies relating to conduct, ethics, and business practices are followed. Losses from operational risks may still occur, however, including losses from the effects of operational errors.

First Defiance's operations are also dependent on its existing infrastructure, including equipment and facilities. Extended disruption of vital infrastructure as a result of fire, power loss, natural disaster, telecommunications failures, computer hacking or viruses, terrorist activity or the domestic response to such activity, or other events outside of the control of management could have a material adverse impact on its business, results of operations, cash flows and financial condition. First Defiance has a business recovery plan, but there are no assurances that such a plan will work as intended or that it will prevent significant interruptions to operations.

### **Unauthorized disclosure of sensitive or confidential client or customer information, whether through a breach of the Company's computer systems or otherwise, could severely harm its business.**

In the normal course of business, First Defiance collects, processes and retains sensitive and confidential client and customer information on behalf of First Defiance and other third parties. Despite the security measures the Company has in place, First Defiance's facilities and systems, and those of the Company's third party service providers, may be vulnerable to security breaches, act of vandalism, computer viruses, lost or misplaced data, or other similar events. Any security breach involving the unauthorized disclosure or loss of confidential customer information, whether by First Defiance or by the Company's third party vendors, could severely damage First Defiance's reputation, expose the Company to risks of litigation and liability, disrupt First Defiance's operations and have a material adverse effect on First Defiance's business.

## Table of Contents

### **The issuance of Series A Preferred Shares and Warrants to the U. S. Government may adversely affect the holders of First Defiance's Common Shares.**

First Defiance issued 37,000 Series A Preferred Shares and warrants to purchase 550,595 shares of First Defiance common stock (the "Common Shares") to the U.S. Department of the Treasury under the Capital Purchase Program. The dividends accrued and the accretion on discount on the Series A Preferred Shares issued to the U.S. Treasury reduce the net income available to the holders of our Common Shares and our earnings per Common Share. Because the Series A Preferred Shares are cumulative, any dividends not declared or paid will accumulate and will be payable when the payment of dividends is resumed. If the Series A Preferred Shares are not redeemed within five years after their original date of issuance, the annual dividend rate on the Series A Preferred Shares will increase from 5.0% per annum to 9.0% per annum. If First Defiance is unable to redeem the Series A Preferred Shares by December 5, 2013, the increase in the annual dividend rate on the Series A Preferred Shares could have a material adverse effect on the Company's earnings and could also adversely affect its ability to declare and pay dividends on its Common Shares. Series A Preferred Shares will also receive preferential treatment in the event of a liquidation, dissolution or winding up of First Defiance.

The Common Shares underlying the Warrant represent approximately 5.4% of the Common Shares outstanding as of December 31, 2011 (including the shares issuable upon exercise of the Warrant in our total outstanding Common Shares). If the Warrant is exercised, the interest of the existing holders of Common Shares will be diluted. Although the Treasury Department has agreed not to vote any of the Common Shares acquired upon exercise of the Warrant, a transferee of the Warrant or of any Common Shares acquired upon exercise of the Warrant is not bound by this restriction. Finally, the terms of the Series A Preferred Shares allow the U.S. Treasury to impose additional restrictions, including those on dividends and to unilaterally amend the terms of the Series A Preferred Shares to comply with changes in applicable federal law.

If First Defiance fails to pay dividends on the Series A Preferred Shares for six quarterly dividend periods (whether or not consecutive), the Treasury Department will have the right to appoint two directors to the Company's Board of Directors until all accrued but unpaid dividends have been paid. As long as the Series A Preferred Shares are outstanding, in addition to any other vote or consent of shareholders required by law or our Articles of Incorporation, as amended (the "Articles"), the vote or consent of holders owning at least 66 2/3% of the Series A Preferred Shares outstanding is required for:

any authorization or issuance of shares ranking senior to the Series A shares;

any amendments to the rights of the Series A Preferred Shares that would adversely affect the rights, preferences, privileges or voting power of the Series A shares; or

the consummation of any merger, share exchange or similar transaction unless the Series A shares remain outstanding, or if we are not the surviving entity in such transaction, are converted into or exchanged for preference securities of the surviving entity and the Series A shares remaining outstanding or such preference securities have the rights, preferences, privileges and voting power of the Series A shares.

The holders of Series A Preferred Shares, including the U.S. Treasury, may have different interests from the holders of the Common Shares, and could vote to block transactions that may be in the best interest of the present holders of the Common Shares.



## **Table of Contents**

**First Defiance may need to raise additional capital in the future, which may result in significant dilution to holders of the Common Shares.**

There can be no assurance that First Defiance will not in the future determine that it is advisable, or that it will not encounter circumstances where the Company determines that it is necessary, to issue additional Common Shares, securities convertible into or exchangeable for Common Shares or common-equivalent securities to fund strategic initiatives or other business needs or to build additional capital. In addition, if the Company decides to repurchase the Series A Preferred Stock issued to the U.S. Treasury, it may elect or be required by its regulators to increase the amount of our Tier 1 common equity through the sale of additional Common Shares. Further, there can be no assurance that the regulators will not require the Company to generate additional capital, including Tier 1 common equity, in the future in the event of further negative economic circumstances, in order for First Defiance to redeem the Series A Preferred Stock held by the U.S. Treasury under the CPP or otherwise. The market price of the Common Shares could decline as a result of such exchange offerings, as well as other sales of a large block of the Common Shares or similar securities in the market thereafter, or the perception that such sales could occur. These factors could have a material adverse effect on the Company.

**The Company may not be permitted to repurchase the U.S. Treasury's CPP investment if and when it requests approval to do so.**

While it is the Company's plan to repurchase the Series A Preferred Stock as soon as practicable, in order to repurchase such securities, in whole or in part, it must establish to its regulators' satisfaction that all of the conditions to repurchase have been met and must obtain the approval of its primary federal regulator and the U.S. Treasury. There can be no assurance that the Company will be able to repurchase the U.S. Treasury's CPP investment in the Series A Preferred Stock subject to conditions that the Company finds acceptable, or at all. In addition to limiting First Defiance's ability to return capital to its shareholders, the U.S. Treasury's investment could limit the Company's ability to retain key executives and other key employees because of the limits on compensation that may be paid to employees of CPP participants, and limit the Company's ability to develop business opportunities.

**If the Company is unable to redeem the Series A Preferred Stock within five years from the issuance date, the cost of this capital will increase substantially.**

If the Company is unable to redeem the Series A Preferred Stock prior to December 5, 2013, the cost of this capital will increase substantially on that date, from 5.0% per annum (approximately \$1.9 million annually) to 9.0% per annum (approximately \$3.3 million annually). Depending on our financial condition at the time, this increase in the annual dividend rate could have a material negative effect on the Company's liquidity.

**Regulatory restriction on dividends and First Defiance's ability to repurchase shares may adversely affect its shareholders and the market price of the Common Shares.**

As long as the Series A shares are outstanding and held by the Treasury Department, the Company cannot increase the quarterly dividend on the Common Shares above \$.26 per share without prior approval from the Treasury Department. In addition to this restriction, the Federal Reserve has directed First Defiance to seek approval of the Federal Reserve before paying any dividends on the Common Shares.

The Company's principal source of funds to pay dividends on the Common Shares is distributions from First Federal, which require the prior approval of the OCC. The OCC has advised

## **Table of Contents**

First Defiance that it is not likely to approve any distributions from First Federal for this purpose in the foreseeable future. The Federal Reserve and the OCC have also advised the Company that it should not pay dividends utilizing borrowings or other sources of funds that it may have access to.

As long as the Series A shares are outstanding and held by the Treasury Department, the Company cannot repurchase Common Shares without the consent of the Treasury Department (other than repurchases in connection with the administration of any employee benefit plan in the ordinary course of business and consistent with past practice and certain other exemptions). Further, the Federal Reserve has directed First Defiance to seek approval of the Federal Reserve before repurchasing any Common Shares.

### **Item 1B. Unresolved Staff Comments**

None.

### **Item 2. Properties**

At December 31, 2011, First Federal conducted its business from its main office at 601 Clinton Street, Defiance, Ohio, and thirty-two other full service banking centers in northwest Ohio, northeast Indiana and southeast Michigan. First Insurance conducted its business from leased office space at 419 5<sup>th</sup> Street, Suite 1200, Defiance, Ohio; 209 West Poe Road, Bowling Green, Ohio; 214 N. Defiance Street, Archbold, Ohio; 926 East High Street, Bryan, Ohio; 1755 Indian Wood Circle, Maumee, Ohio and 4350 Navarre Ave, Oregon, Ohio.

In 2009, the Company closed two branch locations, the Cole Street branch in Lima, Ohio which was owned, and the Hillsdale, Michigan branch which was leased. As of December 31, 2009, the Cole Street branch in Lima, Ohio was transferred at its fair value of \$300,000 to other real estate owned and is currently held for sale. As of December 31, 2011, the value in other real estate owned was \$250,000. Also, the Hillsdale branch leasehold improvements were written down to a value of \$0. These two branches were closed on January 22, 2010.

First Defiance maintains its headquarters in the main office of First Federal at 601 Clinton Street, Defiance, Ohio. Back-office operation departments, including information technology, loan processing and underwriting, deposit processing, accounting and risk management are headquartered in an operations center located at 25600 Elliott Road, Defiance, Ohio.

**Table of Contents**

The following table sets forth certain information with respect to the office and other properties of the Company at December 31, 2011. See Note 10 to the Consolidated Financial Statements.

Description/address	Leased/Owned	Net Book Value of Property (In Thousands)	Deposits
<b>Main Office, First Federal</b>			
601 Clinton St., Defiance, OH	Owned	\$ 4,311	\$ 225,669
<b>Operations Center</b>			
25600 Elliott Rd., Defiance, OH	Owned	5,646	N/A
<b>Mobile Banking</b>			
1011 W. Beecher St., Adrian, MI	Owned	204	N/A
<b>Branch Offices, First Federal</b>			
204 E. High St., Bryan, OH*	Owned	724	128,378
211 S. Fulton St., Wauseon, OH	Owned	498	54,527
625 Scott St., Napoleon, OH	Owned	1,095	69,751
1050 East Main St., Montpelier, OH	Owned	372	39,580
926 East High St., Bryan, OH*	Owned	88	
1800 Scott St., Napoleon, OH	Owned	1,364	26,505
1177 N. Clinton St., Defiance, OH	Owned, Land Lease	971	38,145
905 N. Williams St., Paulding, OH	Owned	801	44,625
201 E. High St., Hicksville, OH	Owned	385	26,071
3900 N. Main St., Findlay, OH	Owned	1,020	47,226
11694 N. Countyline St., Fostoria, OH	Owned	663	34,338
1226 W. Wooster, Bowling Green, OH	Owned	1,047	84,354
301 S. Main St., Findlay, OH	Owned	1,076	45,282
405 E. Main St., Ottawa, OH	Owned	354	77,539
124 E. Main St., McComb, OH	Owned	204	21,397
7591 Patriot Dr., Findlay, OH	Owned	1,173	42,048
417 W Dussell Dr., Maumee, OH	Owned, Land Lease	912	47,135
230 E. Second St., Delphos, OH	Owned	1,075	94,715
105 S. Greenlawn Ave., Elida, OH	Owned	341	40,024
2600 Allentown Rd., Lima, OH	Owned	821	40,652
22020 W. State Rt. 51, Genoa, OH	Owned	892	31,295
3426 Navarre Ave., Oregon, OH	Owned	977	28,849
1077 Louisiana Ave., Perrysburg, OH	Owned	1,117	27,690
2565 Shawnee Rd., Lima, OH	Owned	1,508	27,944
7437 Coldwater Rd., Fort Wayne, IN	Leased	120	10,062
135 South Main St., Glandorf, OH	Leased		14,796
300 N. Main St., Adrian, MI	Owned	765	64,455
1701 W. Maumee St., Adrian, MI	Owned	162	54,737
211 W. Main St., Morenci, MI	Owned	171	27,224
539 S. Meridian, Hudson, MI	Owned	596	40,348
1449 W. Chicago Blvd., Tecumseh, MI	Owned	1,530	25,125
501 E. Chicago Blvd., Tecumseh, MI	Leased	9	15,755
<b>First Insurance Group</b>			
419 5 <sup>th</sup> Street, Suite 1200, Defiance, OH	Leased	94	N/A
209 West Poe Road, Bowling Green, OH	Leased	13	N/A
214 N. Defiance St., Archbold, OH	Leased		N/A
926 E. High St., Bryan, OH**	Leased		N/A
1755 Indian Wood Circle, Maumee, OH	Leased		N/A
4350 Navarre Ave, Oregon, OH	Leased		N/A
		\$ 33,099	\$ 1,596,241



**Table of Contents**

\* The Bryan East (926 East High St.) deposits are now included in the Bryan Main (204 E. High Street) totals.

\*\* Located in the Bryan East branch.

-33-

**Table of Contents****Item 3. Legal Proceedings**

First Defiance is involved in routine legal proceedings occurring in the ordinary course of business which, in the aggregate, are believed by management to be immaterial to the financial condition of First Defiance.

**Item 4. Reserved****PART II****Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities**

The Company's common stock trades on The NASDAQ Global Select Market under the symbol FDEF. As of February 29, 2012, the Company had 2,205 shareholders of record.

The table below shows the reported high and low sales prices of the common stock and cash dividends declared per share of common stock during the periods indicated in 2011 and 2010.

Quarter ended:	Years Ending					
	December 31, 2011			December 31, 2010		
	High	Low	Dividend	High	Low	Dividend
March 31	\$ 14.64	\$ 11.89	\$	\$ 12.33	\$ 9.20	\$
June 30	15.00	13.22		14.85	8.53	
September 30	15.51	12.60		10.63	8.55	
December 31	15.39	13.00	0.05	12.32	9.94	

First Defiance's ability to pay dividends to its shareholders is primarily dependent on the ability of the Subsidiaries to pay dividends to First Defiance. The OCC advised the Company that prior approval would be required to pay dividends utilizing borrowings or other sources of funds to which the Company may have access to. Capital distributions include, without limitation, payments of cash dividends, repurchases and certain other acquisitions by an association of its shares and payments to stockholders of another association in an acquisition of such other association.

Even if the OCC approves a distribution from First Federal to First Defiance, as a result of participating in the CPP, First Defiance is prohibited, without prior approval of the U.S. Treasury, from paying a quarterly cash dividend of more than \$0.26 per share as long as the Series A shares are outstanding and held by the Treasury Department.

First Federal paid \$4.8 million in dividends to First Defiance during 2010. First Insurance paid \$1.0 million in dividends to First Defiance during 2010. There were no dividends paid by First Federal or First Insurance in 2011.

The line graph below compares the yearly percentage change in cumulative total shareholder return on First Defiance common stock and the cumulative total return of the NASDAQ Composite Index, the SNL NASDAQ Bank Index and the SNL Midwest Thrift Index. An investment of \$100 on December 31, 2006, and the reinvestment of all dividends are assumed. The performance graph represents past performance and should not be considered to be an indication of future performance.

**Table of Contents**

<i>Index</i>	<i>Period Ending</i>					
	12/31/06	12/31/07	12/31/08	12/31/09	12/31/10	12/31/11
First Defiance Financial Corp.	100.00	75.48	28.37	43.56	45.92	56.49
NASDAQ Composite	100.00	110.66	66.42	96.54	114.06	113.16
SNL Bank NASDAQ Index	100.00	78.51	57.02	46.25	54.57	48.42
SNL Midwest Thrift Index	100.00	84.47	75.06	63.22	51.25	45.21

First Defiance did not purchase any of its common shares during 2011, but has 93,124 shares that may be purchased under a plan announced by the Board of Directors on July 18, 2003. Participation in the CPP prohibits the Company from repurchasing any of its common shares without the prior approval of the U.S. Treasury as long as the Series A shares are outstanding and held by the Treasury Department.

**Table of Contents****Item 6. Selected Financial Data**

The following table is derived from the Company's audited financial statements as of and for the five years ended December 31, 2011. The following consolidated selected financial data should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations and the Consolidated Financial Statements and related notes included elsewhere in this Form 10-K. The operating results of the acquired companies are included with the Company's results of operations since their respective dates of acquisition.

	2011	As of and For the Year Ended December 31			
		2010	2009	2008	2007
		(Dollars in Thousands, Except Per Share Data)			
Financial Condition:					
Total assets	\$ 2,068,190	\$ 2,035,517	\$ 2,057,523	\$ 1,957,400	\$ 1,609,404
Investment securities	233,580	166,091	139,378	118,461	113,487
Loans receivable, net	1,453,822	1,478,423	1,580,575	1,592,643	1,275,806
Allowance for loan losses	33,254	41,080	36,547	24,592	13,890
Nonperforming assets (1)	46,336	56,632	61,433	41,267	11,677
Deposits and borrowers' escrow balances	1,597,643	1,576,356	1,580,891	1,470,564	1,218,620
FHLB advances	81,841	116,885	146,927	156,067	139,536
Stockholders' equity	278,127	240,331	234,086	229,159	165,954
Share Information:					
Basic earnings per share	1.44	0.75	0.64	0.91	1.96
Diluted earnings per share	1.42	0.75	0.63	0.91	1.94
Book value per common share	24.74	25.00	24.26	23.67	23.51
Tangible book value per common share	17.78	17.16	16.44	15.67	17.79
Cash dividends per common share	0.05		0.295	0.95	1.01
Dividend payout ratio	3.47%	NM	46.09%	10.44%	51.53%
Weighted average diluted shares outstanding	9,540	8,153	8,196	7,919	7,178
Shares outstanding end of period	9,726	8,118	8,118	8,117	7,059
Operations:					
Interest income	\$ 87,067	\$ 95,865	\$ 100,579	\$ 103,463	\$ 98,751
Interest expense	17,186	25,702	33,257	41,268	50,089
Net interest income	69,881	70,163	67,322	62,195	48,662
Provision for loan losses	12,434	23,177	23,232	12,585	2,306
Non-interest income	27,516	27,590	26,295	19,069	22,130
Non-interest expense	62,764	63,463	60,524	57,794	48,113
Income before tax	22,199	11,113	9,861	10,885	20,373
Federal income tax	6,665	3,005	2,667	3,528	6,469
Net Income	15,534	8,108	7,194	7,357	13,904
Performance Ratios:					
Return on average assets	0.75%	0.39%	0.36%	0.40%	0.90%
Return on average equity	5.89%	3.40%	3.09%	3.85%	8.48%
Interest rate spread (2)	3.69%	3.68%	3.50%	3.51%	3.17%
Net interest margin (2)	3.88%	3.89%	3.76%	3.80%	3.55%
Ratio of operating expense to average total assets	3.05%	3.09%	2.99%	3.12%	3.12%
Efficiency ratio (3)	63.62%	63.89%	61.50%	67.74%	67.29%
Capital Ratios:					
Equity to total assets at end of period	13.45%	11.81%	11.38%	11.71%	10.31%
Tangible common equity to tangible assets at end of period	8.65%	7.06%	6.69%	6.72%	8.00%
Average equity to average assets	12.82%	11.62%	11.49%	10.30%	10.62%
Asset Quality Ratios:					
Nonperforming assets to total assets at end of period (1)	2.24%	2.78%	2.99%	2.11%	0.73%
Allowance for loan losses to total loans*	2.24%	2.70%	2.26%	1.52%	1.08%
Net charge-offs to average loans	1.41%	1.21%	0.70%	0.41%	0.16%



## Edgar Filing: FIRST DEFIANCE FINANCIAL CORP - Form 10-K

- (1) *Nonperforming assets consist of non-accrual loans that are contractually past due 90 days or more; loans that are deemed impaired under the criteria of FASB ASC Topic 310; loans that have been restructured; and real estate, mobile homes and other assets acquired by foreclosure or deed-in-lieu thereof.*
- (2) *Interest rate spread represents the difference between the weighted average yield on interest-earnings assets and the weighted average rate on interest-bearing liabilities. Net interest margin represents net interest income as a percentage of average interest-earnings assets. Interest income on tax-exempt securities and loans has been adjusted to a tax-equivalent basis using the statutory federal income tax rate of 35%.*
- (3) *Efficiency ratio represents non-interest expense divided by the sum of tax-equivalent net interest income plus non-interest income, excluding securities gain or losses, net.*
- \* *Total loans are net of undisbursed loan funds and deferred fees and costs.*

-36-

## **Table of Contents**

### **Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations** **Forward-Looking Statements and Factors that Could Affect Future Results**

Certain statements contained in this Annual Report on Form 10-K that are not statements of historical fact constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 ( "Act" ), notwithstanding that such statements are not specifically identified as such. In addition, certain statements may be contained in the Company's future filings with the SEC, in press releases, and in oral and written statements made by or with the approval of the Corporation that are not statements of historical fact and constitute forward-looking statements within the meaning of the Act. Examples of forward-looking statements include, but are not limited to: (i) projections of revenues, expenses, income or loss, earnings or loss per common share, the payment or nonpayment of dividends, capital structure and other financial items; (ii) statements of plans, objectives and expectations of First Defiance or its management or Board of Directors, including those relating to products or services; (iii) statements of future economic performance; and (iv) statements of assumptions underlying such statements. Words such as "believes" , "anticipates" , "expects" , "intends" , "targeted" , "continue" , "remain" , "will" , "should" , "may" and other similar expressions are forward-looking statements but are not the exclusive means of identifying such statements.

Forward-looking statements involve risks and uncertainties that may cause actual results to differ materially from those in such statements. Factors that could cause actual results to differ from those discussed in the forward-looking statements include, but are not limited to:

Local, regional, national and international economic conditions and the impact they may have on the Company and its customers and the Company's assessment of that impact.

Volatility and disruption in national and international financial markets.

Government intervention in the U.S. financial system.

Changes in the level of non-performing assets and charge-offs.

Changes in estimates of future reserve requirements based upon the periodic review thereof under relevant regulatory and accounting requirements.

The effects of and changes in trade and monetary and fiscal policies and laws, including the interest rate policies of the Federal Reserve Board.

Inflation, interest rate, securities market and monetary fluctuations.

Political instability.

Acts of God or of war or terrorism.

The timely development and acceptance of new products and services and perceived overall value of these products and services by users.

## Edgar Filing: FIRST DEFIANCE FINANCIAL CORP - Form 10-K

Changes in consumer spending, borrowing and saving habits.

Changes in the financial performance and/or condition of the Company's borrowers.

Technological changes including core system conversions.

Acquisitions and integration of acquired businesses.

The ability to increase market share and control expenses.

Changes in the competitive environment among financial holding companies and other financial service providers.

The effect of changes in laws and regulations (including laws and regulations concerning taxes, banking, securities and insurance) with which the Company and the subsidiaries must comply.

-37-

## **Table of Contents**

The effect of changes in accounting policies and practices, as may be adopted by the regulatory agencies, as well as the Public Company Accounting Oversight Board, the Financial Accounting Standards Board and other accounting standard setters.

The costs and effects of legal and regulatory developments including the resolution of legal proceedings or regulatory or other governmental inquiries and the results of regulatory examinations or reviews.

Greater than expected costs or difficulties related to the integration of new products and lines of business.

The Company's success at managing the risks involved in the foregoing items.

Forward-looking statements speak only as of the date on which such statements are made. The Company undertakes no obligation to update any forward-looking statement to reflect events or circumstances after the date on which such statement is made or to reflect the occurrence of unanticipated events.

The following section presents information to assess the financial condition and results of operations of First Defiance. This section should be read in conjunction with the consolidated financial statements and the supplemental financial data contained elsewhere in this Annual Report on Form 10-K.

### **Overview**

First Defiance is a unitary thrift holding company which conducts business through its subsidiaries, First Federal and First Insurance.

First Federal is a federally chartered stock savings bank that provides financial services to communities based in northwest Ohio, northeast Indiana, and southeastern Michigan where it operates 33 full service banking centers in 12 northwest Ohio counties, 1 northeast Indiana county, and 1 southeastern Michigan county.

First Federal provides a broad range of financial services including checking accounts, savings accounts, certificates of deposit, real estate mortgage loans, commercial loans, consumer loans, home equity loans and trust and wealth management services through its extensive branch network.

First Insurance sells a variety of property and casualty, group health and life and individual health and life insurance products. Insurance products are sold through First Insurance is an insurance agency that does business in the Defiance, Archbold, Bryan, Bowling Green, Maumee and Oregon, Ohio areas, offering property and casualty, and group health and life insurance products. On July 1, 2011, the Company completed its acquisition of Payak-Dubbs Insurance Agency, Inc. (PDI), an independent property and casualty insurance agency with two office locations based in Maumee, Ohio and Oregon, Ohio for a cash price of \$4.8 million. PDI was merged into First Insurance. In May 2010, First Insurance acquired a group medical benefits business line from Andres O'Neil & Lowe Insurance Agency. See Note 4 Acquisitions in the Notes to the Financial Statements.

### **Business Strategy**

First Defiance's primary objective is to be a high performing community banking organization, well regarded in its market areas. First Defiance accomplishes this through emphasis on local decision making and empowering its employees with tools and knowledge to serve its customers needs. First Defiance believes in a Customer First philosophy that is strengthened by its Trusted Advisor initiative. First Defiance also has a tagline of Bank with the people you know and trust as an indication of its commitment to local, responsive, personalized service. First Defiance believes this strategy results in greater customer loyalty and profitability through core relationships. First Defiance is focused on diversification of revenue sources and increased market penetration in areas where the growth potential

## **Table of Contents**

exists for a balance between acquisition and organic growth. The primary elements First Defiance's business strategy is commercial banking, consumer banking, including the origination and sale of single family residential loans, enhancement of fee income, wealth management and insurance sales, each united by a strong customer service culture throughout the organization.

**Commercial and Commercial Real Estate Lending** Commercial and commercial real estate lending have been an ongoing focus and a major component of First Federal's success. First Federal provides primarily commercial real estate and commercial business loans with an emphasis on owner occupied commercial real estate and commercial business lending with a focus on the deposit balances that accompany these relationships. First Federal's client base tends to be small to middle market customers with annual gross revenues generally between \$1 million and \$50 million. First Federal's focus is also on securing multiple guarantors in addition to collateral where possible. These customers require First Federal to have a high degree of knowledge and understanding of their business in order to provide them with solutions to their financial needs. First Federal's Customer First philosophy and culture complements this need of its clients. First Federal believes this personal service model differentiates First Federal from its competitors, particularly the larger regional institutions. First Federal offers a wide variety of products to support commercial clients including remote deposit capture and other cash management services. First Federal also believes that the small business customer is a strong market for First Federal. First Federal participates in many of the Small Business Administration lending programs. Maintaining a diversified portfolio with an emphasis on monitoring industry concentrations and reacting to changes in the credit characteristics of industries is an ongoing focus.

**Consumer Banking** First Federal offers customers a full range of deposit and investment products including demand, NOW, money market, certificates of deposits, CDARS and savings accounts. First Federal offers a full range of investment products through the wealth management department and a wide variety of consumer loan products, including residential mortgage loans, home equity loans, installment loans and education loans. First Federal also offers online banking services, which include online bill pay along with debit cards.

**Fee Income Development** Generation of fee income and the diversification of revenue sources are accomplished through the mortgage banking operation, insurance subsidiary and the wealth management department as First Defiance seeks to reduce reliance on retail transaction fee income.

**Deposit Growth** First Federal's focus has been to grow core deposits with an emphasis on total relationship banking with both our retail and commercial customers. First Federal has initiated a pricing strategy that considers the whole relationship of the customer. First Federal will continue to focus on increasing its market share in the communities it serves by providing quality products with extraordinary customer service, business development strategies and branch expansion. First Federal will look to grow its footprint in areas believed to further complement its overall market share and complement its strategy of being a high performing community bank.

**Asset Quality** Maintaining a strong credit culture is of the utmost importance to First Federal. First Federal has maintained a strong credit approval and review process that has allowed the Company to maintain a credit quality standard that balances the return with the risks of industry concentrations and loan types. First Federal is primarily a collateral lender with an emphasis on cash flow performance, while obtaining additional support from personal guarantees and secondary sources of repayment. First Federal has directed its attention on loan types and markets that it knows well and in which it has historically been successful in. First Federal strives to have loan relationships that are well diversified in both size and industry, and monitor the overall trends in the portfolio to maintain its industry and loan type concentration targets. First Federal maintains a problem loan remediation process that focuses on detection and resolution. First Federal maintains a strong process of internal control that subjects the loan portfolio to periodic internal reviews as well as independent third party loan review.

**Expansion Opportunities** First Defiance believes it is well positioned to take advantage of acquisitions or other business opportunities in its market areas, including FDIC-assisted transactions.

---

## **Table of Contents**

First Defiance believes it has a track record of successfully accomplishing both acquisitions and de novo branching in its market area. This track record puts the Company in a solid position to enter or expand its business. First Defiance has successfully integrated acquired institutions in the past with the most recent acquisition completed in 2008. First Defiance will continue to be disciplined as well as opportunistic in its approach to future acquisitions and de novo branching with a focus on its primary geographic market area, which it knows well and has been competing in for a long period of time. First Defiance completed its acquisition of PDI, on July 1, 2011, which was merged into First Insurance with offices located in Maumee and Oregon, Ohio.

### **Common Stock Offering**

During the first quarter of 2011, the Company completed an underwritten public common stock offering by issuing 1,600,800 shares of the Company's common stock, including 208,800 shares issued pursuant to the exercise of the underwriter's over-allotment option, at a price of \$13.25 per share for gross proceeds of \$21.2 million. The net proceeds to the Company after deducting underwriting discounts and commissions and offering expenses were \$19.9 million.

### **Financial Condition**

Assets at December 31, 2011 totaled \$2.07 billion compared to \$2.04 billion at December 31, 2010, an increase of \$32.7 million or 1.6%. Cash and equivalents increased \$5.8 million to \$174.9 million at December 31, 2011 from \$169.2 million at December 31, 2010. The increase in assets was a result of the Company's continued strategy to increase security purchases selectively deploying lower yielding overnight deposits into securities on the short to intermediate end of the yield curve until loan demand becomes consistent.

### **Securities**

The securities portfolio increased \$67.5 million to \$233.6 million at December 31, 2011. The 2011 activity in the portfolio included \$120.5 million of purchases, \$25.8 million of amortization and maturities, \$27.0 million of principal pay-downs and \$8.5 million of securities being sold. There was a net increase of \$7.2 million in market value on available-for-sale securities. The Company also recorded \$2,000 of other-than-temporary impairment on one collateralized debt obligation in 2011. See Note 6 Investment Securities in the Notes to the financial statements for additional information.

### **Loans**

Gross loans receivable declined \$32.4 million to \$1.49 billion at December 31, 2011. For more details on the loan balances, see Note 8 Loans Receivable in the Notes to the Financial Statements.

The majority of First Defiance's non-residential real estate and commercial loans are to small and mid-sized businesses. The combined commercial, non-residential real estate and multi-family real estate loan portfolios totaled \$1.13 billion and \$1.14 billion at December 31, 2011 and 2010 respectively and accounted for approximately 75.0% and 74.3% of First Defiance's loan portfolio at the end of those respective periods. First Defiance believes it has been able to establish itself as a leader in its market area in the commercial and commercial real estate lending area by hiring experienced lenders and providing a high level of customer service to its commercial lending clients.

The one-to-four family residential portfolio totaled \$203.4 million at December 31, 2011, compared with \$205.9 million at the end of 2010. At the end of 2011, those loans comprised 13.6% of the total loan portfolio, down from 13.5% at December 31, 2010.

Construction loans, which include one to four family and commercial real estate properties, increased to \$31.6 million at December 31, 2011 compared to \$30.3 million at December 31, 2010. These loans accounted for approximately 2.1% and 2.0% of the total loan portfolio at December 31, 2011 and 2010, respectively.

---

**Table of Contents**

Home equity and home improvement loans declined to \$122.1 million at December 31, 2011, from \$133.6 million at the end of 2010. At the end of 2011, those loans comprised 8.1% of the total loan portfolio, down from 8.7% at December 31, 2010.

Consumer finance and mobile home loans were just \$18.9 million at December 31, 2011, down from \$22.8 million at the end of 2010. These loans comprised just 1.3% and 1.5% of the total portfolio at December 31, 2011 and 2010, respectively.

In order to properly assess the collateral dependent loans included in its loan portfolio, the Company has established policies regarding the monitoring of the collateral underlying such loans. The Company requires an appraisal that is less than one year old for all new collateral dependent real estate loans, and all renewed collateral dependent real estate loans where significant new money is extended. The appraisal process is handled by the Credit Department, which selects the appraiser and orders the appraisal. First Defiance's loan policy prohibits the account officer from talking or communicating with the appraiser to insure that the appraiser is not influenced by the account officer in any way in making their determination of value.

First Federal generally does not require updated appraisals for performing loans unless significant new money is requested by the borrower.

When a collateral dependent loan is downgraded to classified status, First Federal reviews the most current appraisal on file and if necessary, based on First Federal's assessment of the appraisal, such as age, market, etc, First Federal will discount this amount to a more appropriate current value based on inputs from lenders and realtors. This amount may then be discounted further by First Federal's estimation of the carrying and selling costs. In some instances, we may require a new appraisal. Finally, First Federal assesses whether there is any collateral short fall, considering guarantor support and determines if a reserve is necessary.

When a collateral dependent loan moves to non-performing status, First Federal generally gets a new third party appraisal and adjusts the reserve as necessary based upon the new appraisal and an estimate of costs to liquidate the collateral. All properties that are moved into the Other Real Estate Owned ( OREO ) category are supported by current appraisals, and the OREO is carried at the lower of cost or fair value, which is determined based on appraised value less First Federal's estimate of the liquidation costs.

First Federal does not adjust any appraisals upward without written documentation of this valuation change from the appraiser. When setting reserves on classified loans, appraisal values may be discounted downward based upon First Federal's experience with liquidating similar properties.

All loans over 90 days past due and/or on non-accrual as well as all Troubled Debt Restructured loans are classified as non-performing loans. Non-performing status automatically occurs in the month in which the 90 day delinquency occurs. For Troubled Debt Restructured loans, the loans are put into non-performing status in the month in which the restructure occurs.

As stated above, once a collateral dependent loan is identified as non-performing, First Federal generally gets an appraisal. Troubled Debt Restructure collateral dependent loans receive an appraisal as part of the restructure credit decision.

Appraisals are received within approximately 60 days after they are requested. The First Federal Loan Loss Reserve Committee reviews the amount of each new appraisal and makes any necessary adjustment to the reserve at its meeting prior to the end of each quarter.

## **Table of Contents**

Any partially charged-off collateral dependent loans are considered non-performing, and as such, would need to show an extended period of time with satisfactory payment performance as well as cash flow coverage capability supported by current financial statements before First Federal will consider an upgrade to performing status. If the loan maintains a rate at restructuring that is lower than the market rate for similar credits, the loan will remain classified as Troubled Debt Restructuring until such time as it is paid off or restructured at prevailing rates and terms. First Federal may consider moving the loan to accruing status after six months of satisfactory payment performance.

For loans where First Federal determines that an updated appraisal is not necessary, other means are used to verify the value of the real estate, such as recent sales of similar properties on which First Federal had loans as well as calls to appraisers, brokers, realtors and investors. First Federal monitors and tracks its reserves quarterly to determine accuracy. Based on these results, changes may occur in the processes used. The most recent analysis indicates that our actual charge-offs are on average within 10% of the specific reserves previously established for these loans.

Loan modifications constitute a Troubled Debt Restructuring if First Federal for economic or legal reasons related to the borrower's financial difficulties grants a concession to the borrower that it would not otherwise consider. For loans that are considered Troubled Debt Restructurings, First Federal either computes the present value of expected future cash flows discounted at the original loan's effective interest rate or, as a practical expedient, it may measure impairment based on the observable market price of the loan or the fair value of the collateral even though Troubled Debt Restructurings are not expected to be deemed collateral dependent. The difference between the carrying value and fair value of the loan is recorded as a valuation allowance.

### **Allowance for Loan Losses**

The allowance for loan losses represents management's assessment of the estimated probable credit losses in the loan portfolio at each balance sheet date. Management analyzes the adequacy of the allowance for loan losses regularly through reviews of the loan portfolio. Consideration is given to economic conditions, changes in interest rates and the effect of such changes on collateral values and borrower's ability to pay, changes in the composition of the loan portfolio and trends in past due and non-performing loan balances. The allowance for loan losses is a material estimate that is susceptible to significant fluctuation and is established through a provision for loan losses based on management's evaluation of the inherent risk in the loan portfolio. In addition to extensive in-house loan monitoring procedures, the Company utilizes an outside party to conduct an independent loan review of all commercial loan and commercial real estate loan relationships that exceed \$750,000 of aggregate exposure over a twelve month period. Management utilizes the results of this outside loan review to assess the effectiveness of its internal loan grading system as well as to assist in the assessment of the overall adequacy of the allowance for loan losses associated with these types of loans.

The provision for loan losses is determined by management as the amount to be added to the allowance for loan losses after net charge-offs have been deducted to bring the allowance to a level which, in management's best estimate, is necessary to absorb probable credit losses within the existing loan portfolio in the normal course of business. The allowance for loan loss is made up of two basic components. The first component is the specific allowance in which the company sets aside reserves based on the analysis of individual credits. The second component is the general reserve. The general reserve is used to record loan loss reserves for groups of homogenous loans in which the Company estimates the losses incurred in the portfolios based on quantitative and qualitative factors. Due to the uncertainty of risks in the loan portfolio, the Company's judgment on the amount of the allowance necessary to absorb loans losses is approximate.

In establishing specific reserves, First Federal analyzes all loans on its classified and special mention lists at least quarterly and makes judgments about the risk of loss based on the cash flow of the borrower, the value of any collateral and the financial strength of any guarantor in determining the amount of impairment of individual loans and the specific reserve to be recorded.



## **Table of Contents**

For purpose of the general reserve analysis, the loan portfolio is stratified into nine different loan pools based on loan type and by market area to allocate historic loss experience. The loss experience factor applied to the non-impaired loan portfolio was based upon historical losses of the most recent weighted rolling eight quarters ending December 31, 2011.

The stratification of the loan portfolio resulted in a quantitative general allowance of \$19.5 million at December 31, 2011 compared to \$18.3 million at December 31, 2010. The increase in the quantitative allowance was due to the increase in the historical loss factors relating to commercial, commercial real estate, residential and credit card loans.

In addition to the quantitative analysis, a qualitative analysis is performed each quarter to provide additional general reserves on the non-impaired loan portfolio for various factors that have a bearing on its loss content, including but not limited to the following:

Changes in international, national and local economic and business conditions and developments, including the condition of various market segments

Changes in the nature and volume of the loan portfolio

Changes in the trends of the volume and severity of past due and classified loans; and changes in trends in the volume of non-accrual loans, troubled debt restructurings and other loan modifications

The existence and effect of any concentrations of credit and changes in the level of such concentrations

Changes in the value of underlying collateral for collateral dependent loans

Changes in the political and regulatory environment

Changes in lending policies and procedures, including underwriting standards and collection, charge-off and recovery practices

Changes in the experience, ability and depth of lending management and staff

Changes in the quality and breadth of the loan review process

The qualitative analysis at December 31, 2011 indicated a general reserve of \$6.5 million compared with \$6.2 million at December 31, 2010. All 14 counties that represent the footprint of the Company have seen improvements in their unemployment rates in 2011, with six falling below the national average of 8.3%. The unemployment rates in December 2011 range from a low of 7.4% to a high of 13.3% compared to the unemployment rates in 2010 ranging from a low of 8.1% to a high of 16.3%. First Defiance's general reserve percentages for main loan segments not otherwise classified ranged from 0.20% for construction loans to 2.04% for nonresidential real estate loans.

As a result of the quantitative and qualitative analyses, along with the change in specific reserves, the Company's provision for loan losses for 2011 was \$12.4 million compared to \$23.2 million for 2010. The allowance for loan losses was \$33.3 million at December 31, 2011 and \$41.1 million at December 31, 2010 and represented 2.24% and 2.70% of loans, net of undisbursed loan funds and deferred fees and costs, respectively. That decrease was mainly the result of higher charge off activity and improvement in overall credit risk profile. The pace of the decline in real estate values has slowed and in some markets has stabilized. While some collateral dependent loans no longer have enough collateral value to support the outstanding balance Management believes it has processes in place to identify and assess market values. Management has expanded its credit monitoring functions even further beyond its traditionally strong focus. Additional asset review functions and more delinquent loan reporting requirements have been added to assist in this monitoring. Management will continually review credit

concentrations by industry and has placed lower limits on lending within certain types of loan

## **Table of Contents**

categories. Management has also segmented the commercial real estate portfolio to track the general performance of these segments to further refine the predictive process of identifying potential problem loans. The provision was offset by charge offs of \$15.5 million against specific reserves and \$5.9 million against general reserves and recoveries of \$1.2 million resulting in a decrease to the overall allowance for loan loss of \$7.8 million. In management's opinion, the overall allowance for loan losses of \$33.3 million as of December 31, 2011 is adequate.

Management also assesses the value of real estate owned as of the end of each accounting period and recognizes write-downs to the value of that real estate in the income statement if conditions dictate. In 2011, First Defiance recorded OREO write-downs that totaled \$1.0 million. These amounts were included in other non-interest expense. Management believes that the values recorded at December 31, 2011 for real estate owned and repossessed assets represent the realizable value of such assets.

Total classified loans decreased to \$122.5 million at December 31, 2011, compared to \$133.1 million at December 31, 2010. At December 31, 2011, a total of \$18.9 million of loans were classified as substandard for which a specific reserve is required. A total of \$103.6 million in additional credits were classified as substandard at December 31, 2011 for which no specific reserve is required because of factors such as the level of collateral or the strength of guarantors. First Defiance also classified \$10,000 of loans doubtful at December 31, 2011. By contrast, at December 31, 2010, a total of \$47.5 million of loans were classified as substandard for which some level of specific reserve was required and \$83.2 million were classified as substandard which did not require any reserve. At December 31, 2010, \$2.4 million of loans were classified as doubtful.

First Defiance's ratio of allowance for loan losses to non-performing loans was 77.9% at December 31, 2011 compared with 87.3% at December 31, 2010. Management monitors collateral values of all loans included on the watch list that are collateral dependent and believes that allowances for those loans at December 31, 2011 are appropriate.

At December 31, 2011, First Defiance had total non-performing assets of \$46.3 million, compared to \$56.6 million at December 31, 2010. Non-performing assets include loans that are 90 days past due, troubled debt restructured loans and real estate owned and other assets held for sale. Non-performing assets at December 31, 2011 and 2010 by category were as follows:

**Table of Contents**

Table 1 Nonperforming Asset

	December 31	
	2011	2010
	(In thousands)	
Non-performing loans:		
Single-family residential	\$ 3,890	\$ 7,161
Construction		64
Non-residential and multi-family residential real estate	28,150	21,737
Commercial	6,884	11,547
Consumer finance	10	14
Home equity and improvement	394	517
Troubled debt restructured loans, accruing	3,380	6,001
Total non-performing loans	42,708	47,041
Real estate owned and repossessed assets	3,628	9,591
Total non-performing assets	\$ 46,336	\$ 56,632
Allowance for loan losses as a percentage of total loans*	2.24%	2.70%
Allowance for loan losses as a percentage of non-performing assets	71.77%	72.54%
Allowance for loan losses as a percentage of non-performing loans	77.86%	87.33%
Total non-performing assets as a percentage of total assets	2.24%	2.78%
Total non-performing loans as a percentage of total loans*	2.87%	3.10%

\* Total loans are net of undisbursed loan funds and deferred fees and costs.

The decrease in non-performing loans between December 31, 2010 and December 31, 2011 is primarily in single family residential as well as in the commercial loans. The balance of single family residential loans and commercial loans was \$3.3 million and \$4.7 million higher at December 31, 2010 compared to December 31, 2011, respectively. Approximately \$20.0 million of 2010 non-performing loans are still considered non-performing loans at December 31, 2011 and \$2.8 million of real estate owned at December 31, 2011 was in real estate owned at December 31, 2010. The commercial and non-residential real estate and multi-family real estate loans that are non-performing at December 31, 2011 are comprised of 82 relationships, with 9 relationships making up \$20.8 million of the \$35.0 million total. The allowance for loan losses includes \$2.9 million for those 9 relationships. By comparison, at December 31, 2010, 8 relationships made up the \$22.2 million of commercial and non-residential real estate and multi-family real estate loans total of \$33.3 million.

Non-performing loans in the single-family residential, non-residential and multi-family residential real estate and commercial loan categories represent 1.91%, 3.63% and 1.97% of the total loans in those categories respectively at December 31, 2011 compared to 3.48%, 2.83% and 3.12% respectively for the same categories at December 31, 2010. Management believes that the current allowance for loan losses is appropriate and that the provision for loan losses recorded in 2011 is consistent with both charge-off experience and the risk inherent in the overall credits in the portfolio.

Non-performing assets, which include non-accrual loans, accruing troubled debt restructured loans and real estate owned, decreased to \$46.3 million at December 31, 2011 from \$56.6 million at December 31, 2010.

First Federal's Asset Review Committee meets monthly to review the status of work-out strategies for all criticized relationships, which include all non-accrual loans. Based on such factors as anticipated collateral values in liquidation scenarios, cash flow projections, assessment of net worth of guarantors and all other factors which may mitigate risk of loss, the Asset Review Committee makes recommendations regarding required allowances and proposed charge-offs which are approved by the Senior Loan Committee (in the case of charge-offs) or the Loan Loss Reserve Committee (in the case of specific allowances).

**Table of Contents**

The following table details net charge-offs and nonaccrual loans by loan type. For the twelve months ended and as of December 31, 2011, commercial real estate, which represented 51.70% of total loans, accounted for 62.28% of net charge-offs and 71.58% of nonaccrual loans, and commercial loans, which represented 23.25% of total loans, accounted for 19.77% of net charge-offs and 17.50% of nonaccrual loans. For the twelve months ended and as of December 31, 2010, Commercial real estate, which represented 50.14% of total loans, accounted for 52.98% of net charge-offs and 52.96% of nonaccrual loans, and commercial loans, which represented 24.19% of total loans, accounted for 26.06% of net charge-offs and 28.14% of nonaccrual loans.

Table 2 Net Charge-offs and Non-accruals by Loan Type

	For the Twelve Months Ended December 31, 2011		As of December 31, 2011	
	Net Charge-offs	% of Total Net Charge-offs	Nonaccrual Loans	% of Total Non-Accrual Loans
	(in thousands)		(in thousands)	
Residential	\$ 2,626	12.96%	\$ 3,890	9.89%
Construction		0.00%		0.00%
Commercial real estate	12,617	62.28%	28,150	71.58%
Commercial	4,005	19.77%	6,884	17.50%
Consumer finance	25	0.12%	10	0.03%
Home equity and improvement	987	4.87%	394	1.00%
Total	\$ 20,260	100.00%	\$ 39,328	100.00%

	For the Twelve Months Ended December 31, 2010		As of December 31, 2010	
	Net Charge-offs	% of Total Net Charge-offs	Nonaccrual Loans	% of Total Non-Accrual Loans
	(in thousands)		(in thousands)	
Residential	\$ 2,922	15.67%	\$ 7,161	17.45%
Construction		0.00%	64	0.16%
Commercial real estate	9,878	52.98%	21,737	52.96%
Commercial	4,859	26.06%	11,547	28.14%
Consumer finance	17	0.09%	14	0.03%
Home equity and improvement	968	5.19%	517	1.26%
Total	\$ 18,644	100.00%	\$ 41,040	100.00%

**Table of Contents**

Table 3 Allowance for Loan Loss Activity

	4th 2011	3rd 2011	2nd 2011	1st 2011	4th 2010
	For the Quarter Ended				
	(dollars in thousands)				
Allowance at beginning of period	\$ 38,110	\$ 40,530	\$ 40,798	\$ 41,080	\$ 41,343
Provision for credit losses	4,099	3,097	2,405	2,833	5,652
Charge-offs:					
Residential	666	647	893	547	467
Commercial real estate	6,738	2,622	1,517	2,274	4,806
Commercial	1,423	2,533	107	335	388
Consumer finance	27	36	20	11	55
Home equity and improvement	251	290	310	201	363
Total charge-offs	9,105	6,128	2,847	3,368	6,079
Recoveries	150	611	174	253	164
Net charge-offs	8,955	5,517	2,673	3,115	5,915
Ending allowance	\$ 33,254	\$ 38,110	\$ 40,530	\$ 40,798	\$ 41,080

The following table sets forth information concerning the allocation of First Defiance's allowance for loan losses by loan categories at the dates indicated.

Table 4 Allowance for Loan Loss Allocation by Loan Category

	December 31, 2011		September 30, 2011		June 30, 2011		March 31, 2011		December 31, 2010	
	Amount	Percent of total loans by category	Amount	Percent of total loans by category	Amount	Percent of total loans by category	Amount	Percent of total loans by category	Amount	Percent of total loans by category
	(dollars in thousands)									
Residential	\$ 4,095	13.55%	\$ 4,023	12.86%	\$ 5,930	14.62%	\$ 6,163	14.76%	\$ 5,956	13.46%
Construction	63	2.10%	69	2.39%	47	1.64%	70	1.65%	73	1.98%
Commercial real estate	20,490	51.70%	24,523	51.96%	24,397	50.46%	23,390	50.42%	22,355	50.14%
Commercial	6,576	23.25%	7,804	22.99%	8,290	23.10%	9,518	23.06%	10,871	24.19%
Consumer	174	1.26%	219	1.34%	227	1.40%	207	1.41%	297	1.49%
Home equity and improvement	1,856	8.14%	1,472	8.47%	1,639	8.78%	1,450	8.70%	1,528	8.74%
	\$ 33,254	100.00%	\$ 38,110	100.00%	\$ 40,530	100.00%	\$ 40,798	100.00%	\$ 41,080	100.00%

**Key Asset Quality Ratio Trends**

Table 5 Key Asset Quality Ratio Trends

	4th Qtr 2011	3rd Qtr 2011	2nd Qtr 2011	1st Qtr 2011	4th Qtr 2010
Allowance for loan losses / loans*	2.24%	2.61%	2.80%	2.77%	2.70%
Allowance for loan losses to net charge-offs	371.35%	690.77%	1,526.30%	1,309.73%	694.51%
Allowance for loan losses / non-performing assets	71.77%	66.82%	84.16%	74.56%	72.54%

## Edgar Filing: FIRST DEFIANCE FINANCIAL CORP - Form 10-K

Allowance for loan losses / non-performing loans	77.86%	74.39%	99.41%	89.53%	87.33%
Non-performing assets / loans plus REO*	3.11%	3.89%	3.31%	3.70%	3.70%
Non-performing assets / total assets	2.24%	2.77%	2.35%	2.65%	2.78%
Net charge-offs / average loans (annualized)	2.49%	1.55%	0.75%	0.85%	1.58%

\* Total loans are net of undisbursed funds and deferred fees and costs.

-47-

## **Table of Contents**

### **Loans Acquired with Impairment**

Certain loans acquired in the ComBanc, Genoa, and Pavilion acquisitions had evidence that the credit quality of the loan had deteriorated since its origination and in management's assessment at the acquisition date it was probable that First Defiance would be unable to collect all contractually required payments due. In accordance with FASB ASC Topic 310 Subtopic 30, *Loans and Debt Securities Acquired with Deteriorated Credit Quality*, these loans were recorded based on management's estimate of the fair value of the loans. At the acquisition date of January 21, 2005, loans with a contractual receivable of \$3.4 million were acquired from ComBanc and were deemed impaired. Those loans were recorded at a net realizable value of \$2.0 million. On April 8, 2005, loans with a contractual receivable of \$1.5 million were acquired from Genoa and were deemed impaired. Those loans were recorded at a net realizable value of \$721,000. On March 14, 2008, loans with a contractual receivable of \$6.4 million were acquired from Pavilion and were deemed impaired. Those loans were recorded at a net realizable value of \$4.4 million.

As of December 31, 2011, the total contractual receivable for those loans was \$2.2 million and the recorded value was \$1.2 million.

### **High Loan-to-Value Mortgage Loans**

The majority of First Defiance's mortgage loans are collateralized by one-to-four-family residential real estate, have loan-to-value ratios of 80% or less, and are made to borrowers in good credit standing. First Federal usually requires residential mortgage loan borrowers whose loan-to-value is greater than 80% to purchase private mortgage insurance (PMI). Management also periodically reviews and monitors the financial viability of its PMI providers.

First Federal originates and retains a limited number of residential mortgage loans with loan-to-value ratios that exceed 80% where PMI is not required if the borrower possesses other demonstrable strengths. The loan-to-value ratios on these loans are generally limited to 85% and exceptions must be approved by First Federal's senior loan committee. Management monitors the balance of one-to-four family residential loans, including home equity loans and committed lines of credit that exceed certain loan to value standards (90% for owner occupied residences, 85% for non-owner occupied residences and one-to-four family construction loans, 75% for developed land and 65% for raw land). During 2011, management purchased two groups of single family loans to medical professionals that had LTV's greater than 90%. These loans were primarily variable rate loans originated in Ohio in 2011. These purchases led to the growth in the high loan to value mortgage pool. Total loans that exceed those standards described above at December 31, 2011 totaled \$51.7 million, compared to \$25.9 million at December 31, 2010. These loans are generally paying as agreed.

First Defiance does not make interest-only first-mortgage residential loans, nor does it have residential mortgage loan products or other consumer products that allow negative amortization.

### **Goodwill and Intangible Assets**

Goodwill at December 31, 2011 was \$61.5 million compared to \$57.6 million at December 31, 2010. The change in goodwill is due to the acquisition of PDI in July 2011 resulting in an addition to goodwill of \$4.0 million. No impairment of goodwill was recorded in 2011 or 2010. Core deposit intangibles and other intangible assets remained relatively flat at \$6.2 million in 2011 compared to 2010. During 2011, changes to the core deposit intangibles and other intangibles included the recognition of \$1.4 million of amortization expense which was offset by the addition of \$947,000 to the customer relationship intangible asset and \$518,000 to the non-compete intangible asset as a result of the July 2011 acquisition mentioned above.



## **Table of Contents**

### **Deposits**

Total deposits at December 31, 2011 were \$1.596 billion compared to \$1.575 billion at December 31, 2010, an increase of \$20.8 million or 1.3%. Non-interest bearing deposits increased \$29.2 million or 13.5% while interest bearing deposits decreased \$8.4 million or 0.6%. Non-interest bearing checking accounts grew by \$29.2 million, money market and interest bearing checking accounts grew by \$53.6 million, savings grew by \$10.6 million while retail certificates of deposit declined by \$41.5 million. Management periodically utilizes the national market for certificates of deposit to supplement its funding needs. The balance of national CDs decreased to \$10.6 million at December 31, 2011, from \$41.8 million at December 31, 2010. For more details on the deposit balances in general see Note 12 Deposits.

### **Borrowings**

FHLB advances totaled \$81.8 million at December 31, 2011 compared to \$116.9 million at December 31, 2010. The balance at the end of 2011 includes \$44.0 million of convertible advances with rates ranging from 2.35% to 5.44%. These advances are all callable by the FHLB, at which point they would convert to a three-month LIBOR advance if not paid off. Those advances have final maturity dates ranging from 2013 to 2018. In addition, First Defiance has advances totaling \$17.0 million that are callable by the FHLB only if the three-month LIBOR rate exceeds a strike rate ranging from 7.5% to 8.0%. The rate on those advances ranges from 3.48% to 3.85%. Lastly, First Defiance has \$20.8 million of fixed-rate advances with rates ranging from 2.60% to 4.10%. The change in FHLB advances is the result of paying off a \$10.0 million puttable advance and a \$10.0 million strike-rate advance in the first quarter of 2011 at maturity and a \$15.0 million single maturity fixed rate advance at maturity in the third quarter of 2011.

At December 31, 2011, First Defiance also had \$60.4 million of securities that were sold with agreements to repurchase, compared to \$56.2 million of repurchase funding at December 31, 2010.

### **Capital Resources**

Total shareholders' equity increased \$37.8 million to \$278.1 million at December 31, 2011. This increase is primarily the result of the Company's underwritten public common stock offering in the first quarter of 2011 that increased equity a net \$19.9 million, net income of \$15.5 million and a \$4.7 million unrealized gain on available-for-sale securities. These increases were slightly offset by \$1.9 million of preferred stock dividends at December 31, 2011. In 2003, the Company's Board of Directors authorized the repurchase of 640,000 shares, 93,124 of which remain available for repurchase. During 2011, no shares were repurchased but a total of 850 stock options were exercised by four employees, resulting in a \$11,000 increase in shareholders equity. During 2010, no shares were repurchased but a total of 250 stock options were exercised by three employees, resulting in a \$3,000 increase in shareholders equity. Participation in the CPP prohibits the Company from buying back any of its common shares during the period it has CPP funds outstanding.

**Table of Contents****Results of Operations****Summary**

First Defiance reported net income of \$15.5 million for the year ended December 31, 2011 compared to \$8.1 million and \$7.2 million for the years ended December 31, 2010 and 2009, respectively. Net income applicable to common shares was \$13.5 million in 2011 compared with \$6.1 million in 2010 and \$5.2 million in 2009. On a diluted per common share basis, First Defiance earned \$1.42 in 2011, \$0.75 in 2010 and \$0.63 in 2009.

First Defiance's 2011 net income of \$15.5 million included \$234,000 of acquisition related costs resulting from the PDI acquisition in July 2011. The 2011 net income included \$234,000 of acquisition related costs resulting from the PDI acquisition. The 2010 net income included \$63,000 of acquisition related costs resulting from the Andres O'Neil & Lowe Insurance Agency (AOL) acquisition. The 2009 net income did not include any acquisition related costs. Excluding these items, core earnings were \$15.7 million, \$8.1 million and \$7.2 million for the years ended December 31, 2011, 2010 and 2009 respectively. On a diluted per share basis, core earnings amounted to \$1.43, \$0.75 and \$0.63 for those same three periods. Management believes that the presentation of the non-GAAP financial measures assists when comparing results period-to-period in a meaningful and consistent manner and provides a better measure of results for First Defiance's ongoing operations. A reconciliation of GAAP earnings to core earnings is as follows:

	Year Ended December 31		
	2011	2010	2009
	(in thousands)		
GAAP Net Income	\$ 15,534	\$ 8,108	\$ 7,194
One-time acquisition related charges	234	63	
Tax effect	(82)	(22)	
Core Operating Earnings	\$ 15,686	\$ 8,149	\$ 7,194
Basic earnings per common share:			
GAAP	\$ 1.44	\$ 0.75	\$ 0.64
Core Operating Earnings	\$ 1.46	\$ 0.75	\$ 0.64
Diluted earnings per common share:			
GAAP	\$ 1.42	\$ 0.75	\$ 0.63
Core Operating Earnings	\$ 1.43	\$ 0.75	\$ 0.63

**Net Interest Income**

First Defiance's net interest income is determined by its interest rate spread (i.e. the difference between the yields 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.

As demand for new lending opportunities remained soft in 2011, the Company invested some of its liquidity into investment securities. This may continue into 2012 as management deems it appropriate within its liquidity strategy and consideration of overall loan demand.

Net interest income was \$69.9 million for the year ended December 31, 2011 compared to \$70.2 million and \$67.3 million for the years ended December 31, 2010 and 2009 respectively. The tax-equivalent net interest margin was 3.88%, 3.89% and 3.76% for the years ended December 31, 2011, 2010 and 2009 respectively. The margin was relatively flat between 2010 and 2011. Interest-earning asset yields decreased 49 basis points (to 4.80% in 2011 from 5.29% in 2010) and the cost of interest bearing liabilities between the two periods decreased 49 basis points (to 1.12% in 2011 from 1.61% in 2010).



## **Table of Contents**

The increase in margin between 2009 and 2010 is due to a widening of the interest rate spread, which increased to 3.68% for the year ended December 31, 2010 compared to 3.50% for 2009. The increase in spread between 2009 and 2010 occurred due to interest-earning asset yields decreasing by 29 basis points (to 5.29% in 2010 from 5.58% in 2009) which was more than offset by the cost of interest bearing liabilities between the two periods decreasing by 47 basis points (to 1.61% in 2010 from 2.08% in 2009).

Total interest income decreased by \$8.8 million or 9.2% to \$87.1 million for the year ended December 31, 2011 from \$95.9 million for the year ended December 31, 2010. The decrease in interest income was due to a decline in asset yields, mainly as a result of a drop in yields on loans receivable which declined 28 basis points to 5.49% at December 31, 2011. Interest income from loans decreased to \$78.6 million for 2011 compared to \$88.6 million in 2010 which represents a decline of 11.3%.

During the same period the average balance of investment securities increased to \$205.6 million for 2011 from \$154.6 million for the year ended December 31, 2010. Interest income from the investment portfolio increased \$1.0 million from 2010 to 2011. The tax-equivalent yield on the investment portfolio was 4.19% in 2011 compared to 4.71% in 2010. The investment portfolio yield decreased coupled by a narrowing of the overall duration of investments to 3.7 years at December 31, 2011 from 3.9 years at December 31, 2010.

Interest expense decreased by \$8.5 million in 2011 compared to 2010, to \$17.2 million from \$25.7 million. This decrease was due to a 49 basis point decline in the average cost of interest-bearing liabilities in 2011. Interest expense related to interest-bearing deposits was \$12.2 million in 2011 and \$19.2 million in 2010. Expenses on FHLB advances and other interest bearing funding sources were \$3.2 million and \$530,000 respectively in 2011 and \$4.7 million and \$455,000 respectively in 2010. Interest expense recognized by the Company related to subordinated debentures was \$1.3 million in 2011 and 2010.

Total interest income decreased by \$4.7 million or 4.7% to \$95.9 million for the year ended December 31, 2010 from \$100.6 million for the year ended December 31, 2009. The decrease in interest income was due to a decline in asset yields, mainly as a result of a drop in yields on loans receivable which declined 9 basis points to 5.77% at December 31, 2010. Interest income from loans decreased to \$88.6 million for 2010 compared to \$93.7 million in 2009 which represents a decline of 5.4%.

During the same period the average balance of investment securities increased to \$154.6 million for 2010 from \$128.8 million for the year ended December 31, 2009. Interest income from the investment portfolio increased \$282,000 from 2009 to 2010. The tax-equivalent yield on the investment portfolio was 4.71% in 2010 compared to 5.23% in 2009. The investment portfolio yield decreased coupled by a narrowing of the overall duration of investments to 3.9 years at December 31, 2010 from 4.3 years at December 31, 2009.

Interest expense decreased by \$7.6 million in 2010 compared to 2009, to \$25.7 million from \$33.3 million. This decrease was due to a 47 basis point decline in the average cost of interest-bearing liabilities in 2010 which more than offset the \$1.6 million increase in the average balance of those liabilities in 2010. The average balance of interest-bearing deposits increased by \$18.5 million at December 31, 2010 compared to December 31, 2009. Interest expense related to interest-bearing deposits was \$19.2 million in 2010 and \$26.1 million in 2009. Expenses on FHLB advances and other interest bearing funding sources were \$4.7 million and \$455,000 respectively in 2010 and \$5.1 million and \$570,000 respectively in 2009. Interest expense recognized by the Company related to subordinated debentures was \$1.3 million in 2010 compared to \$1.5 million in 2009.

**Table of Contents**

The following table shows an analysis of net interest margin on a tax equivalent basis for the years ended December 31, 2011, 2010 and 2009:

Table 6 Net Interest Margin

	Year Ended December 31 (In Thousands)								
	2011			2010			2009		
	Average Balance	Interest (1)	Yield/ Rate (2)	Average Balance	Interest (1)	Yield/ Rate	Average Balance	Interest (1)	Yield/ Rate
<i>(Dollars in Thousands)</i>									
<b>Interest-Earning Assets:</b>									
Loans receivable	\$ 1,437,588	\$ 78,773	5.49%	\$ 1,538,388	\$ 88,775	5.77%	\$ 1,600,725	\$ 93,850	5.86%
Securities	205,609	8,440	4.19%	154,648	7,151	4.71%	128,806	6,773	5.23%
Interest-earning deposits	184,126	466	0.25%	121,911	303	0.25%	71,366	149	0.21%
FHLB stock	20,831	867	4.17%	21,375	879	4.11%	21,376	955	4.47%
Total interest-earning assets	1,848,154	88,546	4.80%	1,836,322	97,108	5.29%	1,822,273	101,727	5.58%
Non-interest-earning assets	210,216			218,486			202,960		
Total Assets	\$ 2,058,370			\$ 2,054,808			\$ 2,025,233		
<b>Interest-Bearing Liabilities:</b>									
Interest-bearing deposits	\$ 1,358,785	\$ 12,175	0.90%	\$ 1,389,330	\$ 19,222	1.38%	\$ 1,370,826	\$ 26,102	1.90%
FHLB advances	93,669	3,203	3.43%	127,281	4,711	3.70%	146,978	5,114	3.48%
Other borrowings	56,464	530	0.94%	47,046	455	0.97%	44,247	570	1.29%
Subordinated debentures	36,213	1,278	3.54%	36,228	1,314	3.63%	36,208	1,471	4.06%
Total interest-bearing liabilities	1,545,131	17,186	1.12%	1,599,885	25,702	1.61%	1,598,259	33,257	2.08%
Non-interest bearing demand deposits	231,343			200,864			176,513		
Total including non-interest-bearing demand deposits	1,776,474	17,186	0.97%	1,800,749	25,702	1.43%	1,774,772	33,257	1.87%
Other non-interest liabilities	17,983			15,264			17,742		
Total Liabilities	1,794,457			1,816,013			1,792,514		
Stockholders' equity	263,913			238,795			232,719		
Total liabilities and stockholders' equity	\$ 2,058,370			\$ 2,054,808			\$ 2,025,233		
Net interest income; interest rate spread (3)		\$ 71,360	3.69%		\$ 71,406	3.68%		\$ 68,470	3.50%
Net interest margin (4)			3.88%			3.89%			3.76%
Average interest-earning assets to average interest-bearing liabilities			119.6%			114.8%			114.0%

## Edgar Filing: FIRST DEFIANCE FINANCIAL CORP - Form 10-K

- (1) *Interest on certain tax exempt loans (amounting to \$231,000, \$274,000 and \$275,000 in 2011, 2010 and 2009 respectively) and tax-exempt securities (\$2.5 million, \$2.0 million and \$1.8 million in 2011, 2010 and 2009) is not taxable for Federal income tax purposes. The average balance of such loans was \$5.5 million, \$6.1 million and \$6.4 million in 2011, 2010 and 2009 while the average balance of such securities was \$60.5 million, \$47.0 million and \$41.9 million in 2011, 2010 and 2009 respectively. In order to compare the tax-exempt yields on these assets to taxable yields, the interest earned on these assets is adjusted to a pre-tax equivalent amount based on the marginal corporate federal income tax rate of 35%.*
- (2) *At December 31, 2011, the yields earned and rates paid were as follows: loans receivable, 5.14%; securities, 3.60%; FHLB stock, 3.90%; total interest-earning assets, 4.80%; deposits, 0.47%; FHLB advances, 3.68%; other borrowings, 0.90%, subordinated debentures, 3.75%; total interest-bearing liabilities, 0.70%; and interest rate spread, 4.10%.*
- (3) *Interest rate spread is the difference in the yield on interest-earning assets and the cost of interest-bearing liabilities.*
- (4) *Net interest margin is net interest income divided by average interest-earning assets.*

-52-

**Table of Contents**

The following table describes the extent to which changes in interest rates and changes in volume of interest-related assets and liabilities have affected First Defiance's tax-equivalent interest income and interest expense during the periods indicated. For each category of interest-earning assets and interest-bearing liabilities, information is provided on changes attributable to (i) changes in volume (change in volume multiplied by prior year rate), (ii) change in rate (change in rate multiplied by prior year volume), and (iii) total change in rate and volume. The combined effect of changes in both rate and volume has been allocated proportionately to the change due to rate and the change due to volume.

Table 7 Changes in Interest Rates and Volumes

	Year Ended December 31					
	2011 vs. 2010			2010 vs. 2009		
	Increase (decrease) due to rate	Increase (decrease) due to volume	Total increase (decrease)	Increase (decrease) due to rate	Increase (decrease) due to volume	Total increase (decrease)
<b>Interest-Earning Assets</b>						
Loans	\$ (4,352)	\$ (5,650)	\$ (10,002)	\$ (1,461)	\$ (3,614)	\$ (5,075)
Securities	(869)	2,158	1,289	(878)	1,256	378
Interest-earning deposits	6	157	163	33	121	154
FHLB stock	11	(23)	(12)	(76)		(76)
Total interest-earning assets	\$ (5,204)	\$ (3,358)	\$ (8,562)	\$ (2,382)	\$ (2,237)	\$ (4,619)
<b>Interest-Bearing Liabilities</b>						
Deposits	\$ (6,634)	\$ (413)	\$ (7,047)	\$ (7,228)	\$ 348	\$ (6,880)
FHLB advances	(338)	(1,170)	(1,508)	312	(715)	(403)
Term notes	(14)	89	75	(149)	34	(115)
Subordinated Debentures	(35)	(1)	(36)	(158)	1	(157)
Total interest-bearing liabilities	\$ (7,021)	\$ (1,495)	\$ (8,516)	\$ (7,223)	\$ (332)	\$ (7,555)
Increase (decrease) in net interest income			\$ (46)			\$ 2,936

**Provision for Loan Losses** First Defiance's provision for loan losses was \$12.4 million for the year ended December 31, 2011 compared to \$23.2 million for each of the years ended December 31, 2010 and 2009.

Provisions for loan losses are charged to earnings to bring the total allowance for loan losses to a level deemed appropriate by management to absorb probable losses incurred in the loan portfolio. Factors considered by management include identifiable risk in the portfolios, historical experience, the volume and type of lending conducted by First Defiance, the amount of non-performing assets (including loans which meet the FASB ASC Topic 310 definition of impaired), the amount of assets graded by management as substandard, doubtful, or loss, general economic conditions (particularly as they relate to First Defiance's market areas); and other factors related to the collectability of First Defiance's loan portfolio. See also Allowance for Loan Losses in Management's Discussion and Analysis and Note 8 to the audited financial statements.

**Noninterest Income** Noninterest income decreased by \$74,000 or 0.3% in 2011 to \$27.5 million from \$27.6 million for the year ended December 31, 2010. That followed an increase of \$1.3 million or 4.9% in 2010 from \$26.3 million in 2009.

Service fees and other charges decreased to \$11.4 million for the year ended December 31, 2011 from \$12.7 million for 2010 and \$13.5 million for 2009. The decline in income in 2011 and 2010 mainly related to a new rule issued by the Federal Reserve Board that became effective in the third quarter of 2010 as well as changes in customer patterns. This rule prohibits financial institutions from charging consumers fees for paying overdrafts on automated teller machines and one-time debit card transactions,

## **Table of Contents**

unless a consumer consents, or opts in, to the overdraft service for those types of transactions. Consumers must be provided a notice that explains the financial institution's overdraft services, including the fees associated with the service, and the consumer's choices.

First Federal's overdraft privilege program generally provides for the automatic payment of modest overdraft limits on all accounts deemed to be in good standing when the account is accessed using paper-based check processing, a teller withdrawal, a point-of-sale terminal, an ACH transaction, an online banking or voice-response transfer, or an ATM. To be in good standing, an account must be brought to a positive balance within a 30-day period and have not excessively used the overdraft privilege program. Overdraft limits are established for all customers without discrimination using a risk assessment approach for each account classification. The approach includes a systematic review and evaluation of the normal deposit flows made to each account classification to establish reasonable and prudent negative balance limits that would be routinely repaid by normal, expected and reoccurring deposits. The risk assessment by portfolio approach assumes a minimal degree of undetermined credit risk associated with unidentified individual accounts that are overdrawn for 30 or more days. Consumer accounts overdrawn for more than 60 days are automatically charged off. Fees are charged as a one-time fee per occurrence, up to five charges per day, and the fee charged for an item that is paid is equal to the fee charged for a non-sufficient fund item that is returned.

Overdrawn balances, net of allowance for losses, are reflected as loans on First Defiance's balance sheet. The fees charged for this service are established based both on the return of processing costs plus a profit, and on the level of fees charged by competitors in the Company's market area for similar services. These fees are considered to be compensation for providing a service to the customer and therefore deemed to be noninterest income rather than interest income. Fee income recorded for the years ending December 31, 2011 and 2010 related to the overdraft privilege product, net of adjustments to the allowance for uncollectible overdrafts, were \$5.4 million and \$7.3 million, respectively. Accounts charged off are included in noninterest expense. The allowance for uncollectible overdrafts was \$67,000 at December 31, 2011 and \$83,000 at December 31, 2010.

Noninterest income also includes gains, losses and impairment on investment securities. In 2011, First Defiance realized a \$216,000 net gain on securities compared to a \$339,000 net loss in 2010 and a \$3.7 million net loss in 2009. In 2011, 2010 and 2009, First Defiance recognized other-than-temporary impairment ( OTTI ) charges for certain impaired investment securities, where in management's opinion, the value of the investment will not be recovered. The total OTTI charges in 2011 were \$2,000 and gains on sale or call of securities were \$218,000. Management recorded \$2,000 of OTTI on its investment of one trust preferred collateralized debt obligation ( CDOs ) as a result of management's analysis of the securities. The Company held nine CDOs at December 31, 2011. Four of those CDOs were written down in full prior to January 1, 2010. The remaining five CDOs have a total amortized cost of \$3.8 million at December 31, 2011. Of these five, three, with a total amortized cost of \$1.8 million, were identified as OTTI in prior periods. The final two CDOs, with a total amortized cost of \$2.0 million, continue to pay principal and interest payments in accordance with the contractual terms of the securities and no credit loss impairment has been identified in management's analysis. Therefore, these two CDO investments have not been deemed by management to be OTTI. In 2010, there were 30 securities called or matured and four securities sold, resulting in a net loss of \$8,000. The total OTTI charges in 2010 were \$331,000 and losses on sale or call of securities were \$8,000. Management recorded \$214,000 of OTTI on its investments of three trust preferred collateralized debt obligations ( CDOs ) and a \$117,000 write-down of its perpetual preferred securities issued by Fannie Mae and Freddie Mac as a result of management's analysis of the securities. The total OTTI charges in 2009 were \$3.9 million and gains on sale or call of securities were \$284,000. Management recorded \$3.9 million of OTTI on its investment of nine CDOs as a result of management's analysis of the securities. In 2009, there were 21 securities called or matured and 13 securities sold, resulting in a net gain of \$284,000.

Mortgage banking income includes gains from the sale of mortgage loans, fees for servicing mortgage loans for others an offset for amortization of mortgage servicing rights, and adjustments for impairment in the value of mortgage servicing rights. Mortgage banking income totaled \$6.4 million,



## Table of Contents

\$7.8 million and \$9.7 million in 2011, 2010 and 2009, respectively. The \$1.4 million decrease in 2011 from 2010 is attributable to a \$1.4 million decrease in the gain on sale of loans and a \$757,000 negative change in the valuation adjustments on mortgage servicing rights which were partially offset by an increase of \$284,000 in servicing revenue and a decrease of \$473,000 in the amortization of mortgage servicing rights expense. The negative change of \$757,000 in servicing rights valuation adjustments was due to an impairment charge of \$404,000 in 2011 compared with a recapture of \$353,000 in 2010. The impairment charge is a reflection of the decline in the fair value of certain sectors of the Company's portfolio of mortgage servicing rights. First Defiance originated \$262.8 million of residential mortgages for sale into the secondary market in 2011 compared with \$388.1 million in 2010. The \$1.9 million decrease mortgage banking income in 2010 from 2009 is attributable to a \$1.7 million decrease in the gain on sale of loans and a \$961,000 negative change in the valuation adjustments on mortgage servicing rights which were partially offset by an increase of \$259,000 in servicing revenue and a decrease of \$530,000 in the amortization of mortgage servicing rights expense. The negative change of \$961,000 in servicing rights valuation adjustments was due to a recapture of \$353,000 in 2010 compared with a recapture of \$1.3 million in 2009. This was driven by a steady increase in market mortgage rates during 2009. This increase in rates decreased the assumed prepayment speed of the mortgage servicing rights. First Defiance originated \$388.1 million of residential mortgages for sale into the secondary market in 2010 compared with \$513.6 million in 2009. The primary reason for the decrease was the low interest rate environment in the first half of 2009 which led to higher refinance activity. The balance of the mortgage servicing right valuation allowance stands at \$1.5 million at the end of 2011. See Note 9 to the financial statements.

Insurance and investment commission income increased \$2.0 million or 38.3% in 2011 primarily due to the acquisition of PDI, a full insurance agency which closed on July 1, 2011, coupled with an increase in contingent income of \$226,000. The PDI acquisition added approximately \$1.2 million in revenue in 2011. Contingent commissions are bonus payments received by First Defiance's insurance subsidiary for effective underwriting. Insurance and investment commission income increased \$119,000 or 2.3% in 2010 primarily due to an increase in employee benefits premiums of \$469,000 mostly offset by a decline in contingent income of \$328,000. In May 2010, First Insurance acquired a group medical benefits business line from Andres O. Neil & Lowe Insurance Agency.

**Noninterest Expense** Total noninterest expense for 2011 was \$62.8 million compared to \$63.5 million for the year ended December 31, 2010 and \$60.5 million for the year ended December 31, 2009. The 2011 total includes \$234,000 of acquisition related charges and the 2010 total includes \$63,000 of acquisition related charges. Noninterest expense, excluding the acquisition related charges in 2011 and 2010 was \$62.5 million and \$63.4 million, respectively.

Compensation and benefits increased \$4.2 million or 15.2% in 2011 to \$31.6 million from \$27.4 million in 2010. The increase in compensation and benefits is due to the Company freezing pay in 2010, an increase in health care costs of \$813,000 due to an increase in claims, the acquisition of PDI which added approximately \$797,000 in compensation and benefits expense and an increase in incentive expense of \$1.5 million as a direct reflection of the improved financial performance of the Company. FDIC insurance costs decreased \$844,000 or 22.4% to \$2.9 million from \$3.8 million in 2010. The decrease reflects the change in the assessment rate calculation per the Dodd-Frank regulations. Data processing decreased \$652,000 or 13.3% in 2011 to \$4.3 million from \$4.9 million in 2010 as the Company gained efficiencies from switching to a new core systems provider in late 2010. The other noninterest expense category (including acquisition related charges in 2011 and 2010) decreased \$3.5 million due to credit, collection and OREO charges decreasing \$2.1 million and \$1.3 million of core conversion related costs recorded in 2010.

Compensation and benefits decreased \$495,000 or 1.8% in 2010 to \$27.4 million from \$27.9 million in 2009. Compensation declined \$813,000 due to the reduction of approximately 17 full time equivalent positions during the year. Throughout 2009 and 2010, the Company focused on staffing levels and worked to reduce levels without negatively impacting our level of customer service. Work patterns and volumes did change in 2009 due in large part to the economy and lower levels of commercial

## **Table of Contents**

lending. This decline was partially offset by an increase of \$319,000 in benefits and other associated costs. Occupancy cost decreased \$804,000 or 10.2% in 2010 to \$7.0 million from \$7.9 million in 2009. The Company made the decision to close two branch facilities and relocate a third during the fourth quarter of 2009. The closures were completed in January 2010. The costs associated with these closures were reflected in the fourth quarter of 2009 and recorded in other operating expense. FDIC insurance costs increased \$416,000 or 12.4% to \$3.8 million from \$3.4 million in 2009. The increase reflects a general increase in premium rates. Data processing increased \$368,000 or 8.1% in 2010 to \$4.9 million from \$4.5 million in 2009. The other noninterest expense category (including acquisition related charges in 2010) increased \$3.4 million due to credit, collection and OREO charges increasing \$2.1 million, legal and consulting increasing \$284,000, and \$1.3 million of core conversion related costs which were partially offset by a reduction on the loss on the sale of fixed assets of \$549,000.

**Income Taxes** Income taxes amounted to \$6.7 million in 2011 compared to \$3.0 million in 2010 and \$2.7 million in 2009. The effective tax rates for those years were 30.0%, 27.0%, and 27.0%, respectively. The tax rate is lower than the statutory 35% tax rate for the Company mainly because of investments in tax-exempt securities. The earnings on tax-exempt securities are not subject to federal income tax. See Note 19 Income Taxes in the Notes to the financial statements for further details.

## **Concentrations of Credit Risk**

Financial institutions such as First Defiance generate income primarily through lending and investing activities. The risk of loss from lending and investing activities includes the possibility that losses may occur from the failure of another party to perform according to the terms of the loan or investment agreement. This possibility is known as credit risk.

Lending or investing activities that concentrate assets in a way that exposes the Company to a material loss from any single occurrence or group of occurrences increases credit risk. Diversifying loans and investments to prevent concentrations of risks is one way a financial institution can reduce potential losses due to credit risk. Examples of asset concentrations would include multiple loans made to a single borrower and loans of inappropriate size relative to the total capitalization of the institution. Management believes adherence to its loan and investment policies allows it to control its exposure to concentrations of credit risk at acceptable levels. First Defiance's loan portfolio is concentrated geographically in its northwest Ohio, northeast Indiana and southeast Michigan market areas. Management has also identified lending for income-generating rental properties as an industry concentration. Total loans for income generating property totaled \$373.6 million at December 31, 2011, which represents 25.7% of the Company's loan portfolio. Management believes it has the skill and experience to manage any risks associated with this type of lending. Loans in this category are generally paying as agreed without any unusual or unexpected levels of delinquency. The delinquency rate in this category, which is any loan 30 days or more past due, was 5.42% at December 31, 2011. There are no other industry concentrations that exceed 10% of the Company's loan portfolio.

## **Liquidity and Capital Resources**

The Company's primary source of liquidity is its core deposit base, raised through First Federal's branch network, along with wholesale sources of funding and its capital base. These funds, along with investment securities, provide the ability to meet the needs of depositors while funding new loan demand and existing commitments.

Cash generated from operating activities was \$38.5 million, \$32.2 million and \$23.5 million in 2011, 2010 and 2009, respectively. The adjustments to reconcile net income to cash provided by or used in operations during the periods presented consist primarily of proceeds from the sale of loans (less the origination of loans held for sale), the provision for loan losses, depreciation expense, the origination, amortization and impairment of mortgage servicing rights and increases and decreases in other assets and liabilities.

**Table of Contents**

The primary investing activity of First Defiance is lending, which is funded with cash provided from operating and financing activities, as well as proceeds from payment on existing loans and proceeds from maturities of investment securities. On July 1, 2011, First Defiance completed the acquisition of a full insurance agency from Payak-Dubbs Insurance Agency, Inc. for \$4.0 million in cash. Also in 2011, the Company purchased \$25.8 million in portfolio residential home loans. On May 10, 2010, First Defiance completed the acquisition of a line of business from Andres O Neil & Lowe for \$1.5 million in cash.

In considering the more typical investing activities, during 2011, \$52.1 million and \$8.7 million was generated from the combination of maturity, pay-downs, calls or sale of available-for-sale investment securities and \$31.1 million was provided by a decline in loan growth while \$120.5 million was used to purchase available-for-sale investment securities. During 2010, \$46.8 million and \$448,000 was generated from the maturity, pay-downs, calls or sale of available-for-sale investment securities and \$53.8 million was provided by a decline in loan growth while \$76.4 million was used to purchase available-for-sale investment securities. During 2009, \$25.8 million and \$6.4 million was generated from the maturity or sale of available-for-sale investment securities, while \$35.6 million was used to fund loan growth and \$52.6 million was used to purchase available-for-sale investment securities.

Principal financing activities include the gathering of deposits, the utilization of FHLB advances, and the sale of securities under agreements to repurchase such securities and borrowings from other banks. For 2011, total deposits increased by \$21.3 million. The amount of deposits acquired from out of market sources decreased in 2011 by \$31.1 million. For 2010, total deposits decreased by \$4.5 million. The amount of deposits acquired from out of market sources decreased in 2010 by \$5.6 million. For 2009, total deposits increased by \$110.6 million, including \$101.4 million of growth in retail deposits. The amount of deposits acquired from out of market sources increased in 2009 by \$8.9 million. In 2011, securities sold under repurchase arrangements increased by \$4.1 million and the Company completed its common stock offering that increased the financing activities by \$19.9 million. Also in 2010, securities sold under repurchase arrangements increased by \$7.8 million. In 2009, short-term advances from the FHLB decreased by \$9.1 million and there were no borrowings on lines of credit from other banks. Also securities sold under repurchase arrangements decreased by \$1.1 million. For additional information about cash flows from First Defiance's operating, investing and financing activities, see the Consolidated Statements of Cash Flows included in the Consolidated Financial Statements.

At December 31, 2011, First Defiance had the following commitments to fund deposit, advance, borrowing obligations and post-retirement benefits:

Table 8 Contractual Obligations

Contractual Obligations	Maturity Dates by Period at December 31, 2011				
	Total	Less than	1-3 years	4-5 years	After 5
		1 year	(In Thousands)		years
Certificates of deposit	\$ 586,156	\$ 310,735	\$ 269,374	\$ 5,257	\$ 790
FHLB fixed advances including interest (1)	87,581	15,023	54,439	12,977	5,142
Subordinated debentures	36,083				36,083
Securities sold under repurchase agreements	60,386	60,386			
Unrecognized tax benefits	141	76	65		
Lease obligations	7,162	783	891	861	4,627
Post-retirement benefits	1,699	133	286	313	967
Total contractual obligations	\$ 779,208	\$ 387,136	\$ 325,055	\$ 19,408	\$ 47,609

(1) Includes principal payments of \$81,841 and interest payments of \$5,740

**Table of Contents**

At December 31, 2011, First Defiance had the following commitments to fund loan or line of credit obligations:

Table 9 Commitments

Commitments	Total Amounts Committed	Amount of Commitment Expiration by Period			
		Less than 1 year	1-3 years (In Thousands)	4-5 years	After 5 years
Residential real estate loans in process	\$ 16,533	\$ 1,409	\$ 524	\$ 2,493	\$ 12,107
Commercial loans in process	15,048	789	1,081	8,959	4,219
One-to-four family mortgage loan originations	22,565	22,565	0	0	0
Multifamily originations	4,602	4,602	0	0	0
Other real estate originations	22,985	22,243	742	0	0
Nonmortgage loan originations	3,703	3,703	0	0	0
Consumer lines of credit	96,626	8,654	19,442	20,621	47,909
Commercial lines of credit	112,763	103,876	8,887	0	0
Total loan commitments	294,825	167,841	30,676	32,073	64,235
Standby letters of credit	26,107	11,363	14,663	81	0
Total Commitments	\$ 320,932	\$ 179,204	\$ 45,339	\$ 32,154	\$ 64,235

In addition to the above commitments, at December 31, 2011 First Defiance had commitments to sell \$34.5 million of loans to Freddie Mac, Fannie Mae, FHLB of Cincinnati or BB&T Mortgage.

To meet its obligations management can adjust the rate of savings certificates to retain deposits in changing interest rate environments; it can sell or securitize mortgage and non-mortgage loans; and it can turn to other sources of financing including FHLB advances, the Federal Reserve Bank, and brokered certificates of deposit. At December 31, 2011, First Defiance had \$147.9 million capacity under its agreements with the FHLB.

First Federal is subject to various capital requirements of the OCC. At December 31, 2011, First Federal had capital ratios that exceeded the standard to be considered well capitalized. For additional information about First Defiance and First Federal's capital requirements, see Note 18 Regulatory Matters to the Consolidated December 31, 2011 Financial Statements.

**Critical Accounting Policies**

First Defiance has established various accounting policies that govern the application of accounting principles generally accepted in the United States in the preparation of its financial statements. The significant accounting policies of First Defiance are described in the footnotes to the consolidated financial statements. Certain accounting policies involve significant judgments and assumptions by management, which have a material impact on the carrying value of certain assets and liabilities; Management considers such accounting policies to be critical accounting policies. The judgments and assumptions used by management are based on historical experience and other factors, which are believed to be reasonable under the circumstances. Because of the nature of the judgments and assumptions made by management, actual results could differ from these judgments and estimates, which could have a material impact on the carrying value of assets and liabilities and the results of operations of First Defiance.

**Allowance for Loan Losses** First Defiance believes the allowance for loan losses is a critical accounting policy that requires the most significant judgments and estimates used in preparation of its consolidated financial statements. In determining the appropriate estimate for the allowance for loan losses, management considers a number of factors relative to both specific credits in the loan portfolio and macro-economic factors relative to the economy of the United States as a whole and the economy of the northwest Ohio, northeast Indiana and southeast Michigan regions in which the Company does business.

## **Table of Contents**

Factors relative to specific credits that are considered include a customer's payment history, a customer's recent financial performance, an assessment of the value of collateral held, knowledge of the customer's character, the financial strength and commitment of any guarantors, the existence of any customer or industry concentrations, changes in a customer's competitive environment and any other issues that may impact a customer's ability to meet his obligations.

Economic factors that are considered include levels of unemployment and inflation, specific plant or business closings in the Company's market area, the impact of strikes or other work stoppages, the impact of weather or environmental conditions, especially relative to agricultural borrowers, and other matters that may have an impact on the economy as a whole.

In addition to the identification of specific customers who may be potential credit problems, management considers its historical losses, the results of independent loan reviews, an assessment of the adherence to underwriting standards, the loss experience being reported by other financial institutions operating in the Company's market area, and other factors in providing for loan losses that have not been specifically classified. Management believes that the level of its allowance for loan loss is sufficient to cover the estimates loss incurred but not yet recognized on the loan portfolio. Refer to the section titled "Allowance for Loan Losses" and Note 2, Statement of Accounting Policies for a further description of the Company's estimation process and methodology related to the allowance for loan losses.

**Valuation of Mortgage Servicing Rights** First Defiance believes the valuation of mortgage servicing rights is a critical accounting policy that requires significant estimates in preparation of its consolidated financial statements. First Defiance recognizes as separate assets the value of mortgage servicing rights, which are acquired through loan origination activities. First Defiance does not purchase any mortgage servicing rights.

Key assumptions made by management relative to the valuation of mortgage servicing rights include the stratification policy used in valuing servicing, assumptions relative to future prepayments of mortgages, the potential value of any escrow deposits maintained or ancillary income received as a result of the servicing activity and discount rates used to value the present value of a future cash flow stream. In assessing the value of the mortgage servicing rights portfolio, management utilizes a third party that specializes in valuing servicing portfolios. That third party reviews key assumptions with management prior to completing the valuation. Prepayment speeds are determined based on projected median prepayment speeds for 15 and 30 year mortgage backed securities. Those speeds are then adjusted up or down based on the size of the loan. The discount rate used in this analysis is the pretax yield generally required by purchasers of bulk servicing rights as of the valuation date. The value of mortgage servicing rights is especially vulnerable in a falling interest rate environment. Refer also to the section entitled Mortgage Servicing Rights and Note 2 Statement of Accounting Policies, and Note 9 Mortgage Banking, for a further description of First Defiance's valuation process, methodology and assumptions along with sensitivity analyses.

**Valuation of Securities** First Defiance believes the valuation of certain securities is a critical accounting policy that requires significant estimates in preparation of its consolidated financial statements. This is pertaining to the Company's investment in certain trust preferred debt obligations securities (CDOs). As required by FASB ASC Topic 320, declines in the fair value of held-to-maturity and available-for-sale securities below their cost that are deemed to be other-than-temporary, are reflected in earnings as realized losses to the extent the impairment is related to credit losses. The amount of other-than-temporary impairment that does not relate to the credit losses is recognized in other comprehensive income. The fair values of these CDOs, which are backed by trust preferred securities issued by banks, thrifts and insurance companies, have a fair value of \$1.3 million. The market for these securities at December 31, 2011 is not active and markets for similar securities are also not active. The inactivity was evidenced first by a significant widening of the bid-ask spread in the brokered markets in which CDOs trade and then by a significant decrease in the volume of trades relative to historical levels. The new issue market is also inactive as no new CDOs have been issued since 2007. There are currently very few market participants who are willing and/or able to transact for these securities.

**Table of Contents**

The market values for these securities (and any securities other than those issued or guaranteed by the U.S. Treasury) are very depressed relative to historical levels. Thus in today's market, a low market price for a particular bond may only provide evidence of stress in the credit markets in general versus being an indicator of credit problems with a particular issue.

Given the conditions in the debt markets today and the absence of observable transactions in the secondary and new issue markets, management has determined: 1) The few observable transactions and market quotations that are available are not reliable for the purpose of determining fair value at December 31, 2011; 2) An income valuation approach technique (present value technique) that maximizes the use of relevant observable inputs and minimizes the use of observable inputs will be equally or more representative of fair value than the market approach valuation used at the prior measurement dates and 3) The Company's CDOs will be classified within Level 3 of the fair value hierarchy because management determined that significant adjustments were required to determine fair value at the measurement date.

The Company's CDO valuations were supported by an analysis prepared by an independent third party. Their approach to determining fair value involved several steps: 1) Detailed credit and structural evaluation of each piece of collateral in the CDO; 2) Collateral performance projections for each piece of collateral in the CDO (default, recovery and prepayment/amortization probabilities) and 3) Discounted cash flow modeling.

## **Table of Contents**

### **Item 7a. Quantitative and Qualitative Disclosures About Market Risk Asset/Liability Management**

A significant portion of the Company's revenues and net income is derived from net interest income and, accordingly, the Company strives to manage its interest-earning assets and interest-bearing liabilities to generate an appropriate contribution from net interest income. Asset and liability management seeks to control the volatility of the Company's performance due to changes in interest rates. The Company attempts to achieve an appropriate relationship between rate sensitive assets and rate sensitive liabilities. First Defiance does not presently use off balance sheet derivatives to enhance its risk management.

First Defiance monitors interest rate risk on a monthly basis through simulation analysis that measures the impact changes in interest rates can have on net interest income. The simulation technique analyzes the effect of a presumed 100 basis point shift in interest rates (which is consistent with management's estimate of the range of potential interest rate fluctuations) and takes into account prepayment speeds on amortizing financial instruments, loan and deposit volumes and rates, non-maturity deposit assumptions and capital requirements. The results of the simulation indicate that in an environment where interest rates rise 100 basis points over a 24 month period, First Defiance's net interest income would increase by 8.55% over the base case scenario. It should be noted that other areas of First Defiance's income statement, such as gains from sales of mortgage loans and amortization of mortgage servicing rights are also impacted by fluctuations in interest rates but are not considered in the simulation of net interest income.

The majority of First Defiance's lending activities are in non-residential real estate and commercial loan areas. While such loans carry higher credit risk than residential mortgage lending, they tend to be more rate sensitive than residential mortgage loans. The balance of First Defiance's non-residential and multi-family real estate loan portfolio was \$776.0 million, which was split between \$136.7 million of fixed-rate loans and \$639.3 million of adjustable-rate loans at December 31, 2011. The commercial loan portfolio decreased to \$349.1 million, which is split between \$106.0 million of fixed-rate loans and \$243.1 million of adjustable-rate loans at December 31, 2011. Certain loans classified as adjustable have fixed rates for an initial term that may be as long as five years. The maturities on fixed-rate loans are generally less than seven years. First Defiance also has significant balances of home equity and improvement loans (\$122.1 million at December 31, 2011) of which \$74.9 million fluctuate with changes in the prime lending rate. Approximately \$47.2 million of home equity and improvement loans have fixed rates but the maturities on those loans range from three to five years. First Defiance also has consumer loans (\$18.9 million at December 31, 2011) which tend to have a shorter duration than residential mortgage loans. Also, to limit its interest rate risk, as well as to provide liquidity, First Federal sells a majority of its fixed-rate mortgage originations into the secondary market.

In addition to the simulation analysis, First Federal also prepares an economic value of equity (EVE) analysis. For 2011, this analysis calculates the net present value of First Federal's assets and liabilities in rate shock environments that range from -400 basis points to +400 basis points. The likelihood of a decrease in interest rates as of December 31, 2011 was considered to be remote given the current interest rate levels and therefore was not included in this analysis. The results of this analysis are reflected in the following table.

**Table of Contents**

Table 10 Economic Value of Equity Analysis

Change in Rates	December 31, 2011			Economic Value of Equity as % of Present Value of Assets	
	Economic Value of Equity			Ratio	Change
	\$ Amount (Dollars in Thousands)	\$ Change	% Change		
+ 400 bp	471,564	64,772	15.92%	24.08%	450 bp
+ 300 bp	460,756	53,964	13.27%	23.17%	359 bp
+ 200 bp	447,035	40,243	9.89%	22.15%	257 bp
+ 100 bp	430,361	23,570	5.79%	21.00%	142 bp
0 bp	406,792			19.58%	

Change in Rates	December 31, 2010			Economic Value of Equity as % of Present Value of Assets	
	Economic Value of Equity			Ratio	Change
	\$ Amount (Dollars in Thousands)	\$ Change	% Change		
+ 400 bp	264,330	(13,549)	(4.88%)	13.76%	6 bp
+ 300 bp	269,417	(8,462)	(3.05%)	13.83%	13 bp
+ 200 bp	272,867	(5,012)	(1.80%)	13.82%	12 bp
+ 100 bp	276,234	(1,645)	(0.59%)	13.80%	10 bp
0 bp	277,879			13.70%	

The dollar and percentage change in the EVE analysis for 2011 is due to using bank specific decay speeds on non maturity deposits beginning in September 2011 as opposed to using the OTS default speeds. This extended the duration on the funding base resulting in a higher valuation of capital in today's rate environment as well as when term interest rates shift higher.

Based on the above analysis, in the event of a 200 basis point increase in interest rates as of December 31, 2011, First Federal would experience a 9.89% increase in its economic value of equity. During periods of rising rates, the value of monetary assets declines. Conversely, during periods of falling rates, the value of monetary assets increases. It should be noted that the amount of change in value of specific assets and liabilities due to changes in rates is not the same in a rising rate environment as in a falling rate environment. Based on the EVE analysis, the change in the economic value of equity in both rising and falling rate environments is relatively low because both its assets and liabilities have relatively short durations. The average duration of its assets at December 31, 2011 was 1.38 years while the average duration of its liabilities was 3.24 years.



## Edgar Filing: FIRST DEFIANCE FINANCIAL CORP - Form 10-K

In evaluating First Federal's exposure to interest rate risk, certain shortcomings inherent in each of the methods of analysis presented must be considered. For example, although certain assets and liabilities may have similar maturities or periods to repricing, they may react in different degrees to changes in market interest rates. Also, the interest rates on certain types of assets and liabilities may fluctuate in advance of changes in market rates while interest rates on other types of financial instruments may lag behind current changes in market rates. Furthermore, in the event of changes in rates, prepayments and early withdrawal levels could differ significantly from the assumptions in calculating the table and the results therefore may differ from those presented.

-62-

**Table of Contents**

**Item 8. Financial Statements and Supplementary Data**

**Management's Report on Internal Control Over Financial Reporting**

The management of First Defiance Financial Corp. is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rules 13a-15(f). Under the supervision and with the participation of management, we conducted an evaluation of the effectiveness of our internal control over financial reporting based on the framework in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with policies or procedures may deteriorate.

Based on our evaluation under the framework in Internal Control Integrated Framework, management concluded that our internal control over financial reporting was effective as of December 31, 2011.

Crowe Horwath LLP, the independent registered public accounting firm that audited the consolidated financial statements of the Company included in this Annual Report on Form 10-K, has issued a report on the effectiveness of the Company's internal control over financial reporting as of December 31, 2011. The report, which expresses an unqualified opinion on the effectiveness of the Company's internal control over financial reporting as of December 31, 2011, is included below.

William J. Small  
Chairman, President and Chief Executive Officer

Donald P. Hileman  
Executive Vice President and Chief Financial Officer

---

**Table of Contents**

**Report of Independent Registered Public Accounting Firm**

We have audited the accompanying consolidated statements of financial condition of First Defiance Financial Corp. (the Company) as of December 31, 2011 and 2010 and the related consolidated statements of income, changes in stockholders' equity and cash flows for each of the three years in the period ended December 31, 2011. We also have audited First Defiance Financial Corp.'s internal control over financial reporting as of December 31, 2011, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on these financial statements and an opinion on the Company's internal control over financial reporting based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of First Defiance Financial Corp. as of December 31, 2011 and 2010, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2011 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, First Defiance Financial Corp. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2011, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

**Table of Contents**

Crowe Horwath LLP

South Bend, Indiana

March 7, 2012

-65-

## Table of Contents

### First Defiance Financial Corp.

#### Consolidated Statements of Financial Condition

	December 31	
	2011	2010
	<i>(Dollars In Thousands, except share data)</i>	
<b>Assets</b>		
Cash and cash equivalents:		
Cash and amounts due from depository institutions	\$ 31,931	\$ 26,164
Federal funds sold	143,000	143,000
	174,931	169,164
Securities available-for-sale, carried at fair value	232,919	165,252
Securities held-to-maturity, carried at amortized cost (fair value \$672 and \$865 at December 31, 2011 and 2010 respectively)	661	839
	233,580	166,091
Loans held for sale	13,841	18,127
Loans receivable, net of allowance of \$33,254 and \$41,080 at December 31, 2011 and 2010, respectively	1,453,822	1,478,423
Mortgage servicing rights	8,690	9,477
Accrued interest receivable	6,142	6,374
Federal Home Loan Bank (FHLB) stock	20,655	21,012
Bank owned life insurance	35,908	34,979
Premises and equipment	40,045	41,743
Real estate and other assets held for sale (REO)	3,628	9,591
Goodwill	61,525	57,556
Core deposit and other intangibles	6,151	6,128
Deferred taxes	629	5,805
Other assets	8,643	11,047
Total assets	\$ 2,068,190	\$ 2,035,517

**Table of Contents**

## First Defiance Financial Corp

## Consolidated Statements of Financial Condition (continued)

	December 31	
	2011	2010
	<i>(Dollars In Thousands, except share data)</i>	
<b>Liabilities and stockholders' equity</b>		
Liabilities:		
Deposits:		
Noninterest-bearing	\$ 245,927	\$ 216,699
Interest-bearing	1,350,314	1,358,720
Total	1,596,241	1,575,419
Advances from the Federal Home Loan Bank	81,841	116,885
Securities sold under agreements to repurchase and other	60,386	56,247
Subordinated debentures	36,083	36,083
Advance payments by borrowers	1,402	937
Other liabilities	14,110	9,615
Total liabilities	1,790,063	1,795,186
Commitments and Contingent (Note 7)		
Stockholders' equity:		
Preferred stock, \$.01 par value per share: 37,000 shares authorized and issued with a liquidation preference of \$37,231, net of discount	36,641	36,463
Preferred stock, \$.01 par value per share: 4,963,000 shares authorized; no shares issued		
Common stock, \$.01 par value per share: 25,000,000 shares authorized; 12,739,496 and 12,739,496 shares issued and 9,726,243 and 8,117,770 shares outstanding, respectively	127	127
Common stock warrant	878	878
Additional paid-in capital	135,825	140,845
Accumulated other comprehensive income (loss), net of tax of \$2,153 and \$(184), respectively	3,997	(342)
Retained earnings	148,010	134,988
Treasury stock, at cost, 3,013,253 and 4,621,726 shares respectively	(47,351)	(72,628)
Total stockholders' equity	278,127	240,331
Total liabilities and stockholders' equity	\$ 2,068,190	\$ 2,035,517

See accompanying notes.

**Table of Contents**

## FIRST DEFIANCE FINANCIAL CORP.

## Consolidated Statements of Income

(Amounts in Thousands, except per share data)

	Years Ended December 31		
	2011	2010	2009
<b>Interest Income</b>			
Loans	\$ 78,648	\$ 88,628	\$ 93,702
Investment securities:			
Taxable	4,571	4,070	3,976
Tax-exempt	2,515	1,985	1,797
Interest-bearing deposits	466	303	149
FHLB stock dividends	867	879	955
Total interest income	87,067	95,865	100,579
<b>Interest Expense</b>			
Deposits	12,175	19,222	26,102
Federal Home Loan Bank advances and other	3,203	4,711	5,114
Subordinated debentures	1,278	1,314	1,471
Securities sold under agreement to repurchase	530	455	570
Total interest expense	17,186	25,702	33,257
Net interest income	69,881	70,163	67,322
Provision for loan losses	12,434	23,177	23,232
Net interest income after provision for loan losses	57,447	46,986	44,090
<b>Noninterest Income</b>			
Service fees and other charges	11,387	12,740	13,503
Mortgage banking income	6,437	7,847	9,747
Insurance commissions	7,109	5,140	5,021
Gain on sale of non-mortgage loans	361	516	264
Gain (loss) on sale or call of securities	218	(8)	284
Other-than-temporary impairment (OTTI) losses on investment securities			
Total impairment losses on investment securities	(44)	(367)	(4,015)
Losses recognized in other comprehensive income	42	36	75
Net impairment loss recognized in earnings	(2)	(331)	(3,940)
Trust income	599	507	415
Income from bank owned life insurance	929	1,146	557
Other noninterest income	478	33	444
Total noninterest income	27,516	27,590	26,295
<b>Noninterest Expense</b>			
Compensation and benefits	31,554	27,403	27,898
Occupancy	7,166	7,048	7,852
FDIC insurance	2,922	3,766	3,350
Data processing	4,257	4,909	4,541
Acquisition related charges	234	63	
Other noninterest expense	16,631	20,274	16,883
Total noninterest expense	62,764	63,463	60,524

Edgar Filing: FIRST DEFIANCE FINANCIAL CORP - Form 10-K

Income before income taxes	<b>22,199</b>	11,113	9,861
Federal income taxes	<b>6,665</b>	3,005	2,667
Net Income	<b>\$ 15,534</b>	\$ 8,108	\$ 7,194
Dividends Accrued on Preferred Shares	<b>\$ (1,850)</b>	\$ (1,850)	\$ (1,850)
Accretion on Preferred Shares	<b>\$ (178)</b>	\$ (170)	\$ (160)
Net Income Applicable to Common Shares	<b>\$ 13,506</b>	\$ 6,088	\$ 5,184
Earnings per common share:			
Basic	<b>\$ 1.44</b>	\$ 0.75	\$ 0.64
Diluted	<b>\$ 1.42</b>	\$ 0.75	\$ 0.63
Dividends declared per common share	<b>\$ 0.05</b>	\$	\$ 0.295

*See accompanying notes*



**Table of Contents**

## FIRST DEFIANCE FINANCIAL CORP.

## Consolidated Statement of Changes in Stockholders' Equity

(In Thousands, except number of shares)

	Preferred Stock	Common Stock	Common Stock Warrant	Treasury Stock	Additional Paid-In Capital	Stock Acquired by ESOP	Accumulated Other Comprehensive Income (Loss)	Retained Earnings	Total Stockholders' Equity
Balance at January 1, 2009	\$ 36,133	\$ 127	\$ 878	\$ (72,638)	\$ 140,449	\$	\$ (1,904)	\$ 126,114	\$ 229,159
Comprehensive income:									
Net income								7,194	7,194
Change in net unrealized gains and losses on available-for-sale securities, net of income taxes of \$844							1,568		1,568
Change in unrealized gain on postretirement benefit, net of tax of \$96							178		178
Total comprehensive income									8,940
Stock option expense					228				228
400 stock options exercised, with no income tax benefit				7				(2)	5
Preferred stock dividends accrued								(1,850)	(1,850)
Accretion on preferred shares	160							(160)	
Common stock dividends declared								(2,396)	(2,396)
Balance at December 31, 2009	\$ 36,293	\$ 127	\$ 878	\$ (72,631)	\$ 140,677	\$	\$ (158)	\$ 128,900	\$ 234,086
Comprehensive income:									
Net income								8,108	8,108
Change in net unrealized gains and losses on available-for-sale securities, net of income taxes of (\$235)							(436)		(436)
Change in unrealized gain on postretirement benefit, net of tax of \$136							252		252
Total comprehensive income									7,924
Stock option expense					168				168
250 stock options exercised, with no income tax benefit				3					3
Preferred stock dividends accrued								(1,850)	(1,850)
Accretion on preferred shares	170							(170)	
Balance at December 31, 2010	\$ 36,463	\$ 127	\$ 878	\$ (72,628)	\$ 140,845	\$	\$ (342)	\$ 134,988	\$ 240,331
Comprehensive income:									
Net income								15,534	15,534
Change in net unrealized gains and losses on available-for-sale securities, net of income taxes of \$2,516							4,672		4,672
Change in unrealized gain on postretirement benefit, net of tax of (\$179)							(333)		(333)
Total comprehensive income									19,873
Stock option expense					144				144
850 stock options exercised, with no income tax benefit				14				(3)	11

# Edgar Filing: FIRST DEFIANCE FINANCIAL CORP - Form 10-K

1,600,800 shares issued capital stock	25,156	(5,297)	19,859
Restricted share activity under stock incentive plans	75	136	211
2,085 shares issued direct purchases	32	(3)	29
Preferred stock dividends accrued		(1,850)	(1,850)
Accretion on preferred shares	178	(178)	
Common stock dividends declared		(481)	(481)

Balance at December 31, 2011	\$ 36,641	\$ 127	\$ 878	\$ (47,351)	\$ 135,825	\$	\$ 3,997	\$ 148,010	\$ 278,127
------------------------------	-----------	--------	--------	-------------	------------	----	----------	------------	------------

*See accompanying notes*

**Table of Contents**

## FIRST DEFIANCE FINANCIAL CORP.

## Consolidated Statements of Cash Flows

(Amounts in Thousands)

	Years Ended December 31		
	2011	2010	2009
<b>Operating Activities</b>			
Net income	\$ 15,534	\$ 8,108	\$ 7,194
Adjustments to reconcile net income to net cash provided by operating activities:			
Provision for loan losses	12,434	23,177	23,232
Provision for depreciation	3,436	3,403	3,832
Net amortization of premium and discounts on loans, securities, deposits and debt obligations	396	1,503	170
Amortization of mortgage servicing rights	2,169	2,642	3,171
Net impairment (recovery) of mortgage servicing rights	404	(353)	(1,314)
Amortization of intangibles	1,442	1,495	1,456
Gain on sale of loans	(5,968)	(7,533)	(9,008)
Loss on sale or disposals of property, plant and equipment	59	12	563
Loss on sale or write-down of REO	947	4,050	1,627
OTTI losses on investment securities	2	331	3,940
(Gain) loss on sale or call of securities	(218)	8	(284)
Change in deferred taxes	2,839	(2,417)	(4,007)
Proceeds from sale of loans held for sale	263,336	384,492	518,747
Stock option expense	144	168	228
Restricted stock unit expense	211		
Origination of loans held for sale	(262,825)	(388,064)	(513,593)
Income from bank owned life insurance	(929)	(1,146)	(557)
Change in interest receivable and other assets	2,961	3,664	(8,541)
Change in accrued interest and other liabilities	2,365	(1,340)	(3,384)
Net cash provided by operating activities	38,739	32,200	23,472
<b>Investing Activities</b>			
Proceeds from maturities, calls and paydowns of held-to-maturity securities	178	1,081	175
Proceeds from maturities, calls and paydowns of available-for-sale securities	52,097	46,765	25,770
Proceeds from sale of available-for-sale securities	8,719	448	6,383
Proceeds from sale of REO	9,630	10,511	7,076
Proceeds from sale of office properties and equipment	17	1	1,227
Purchases of available-for-sale securities	(120,499)	(76,439)	(52,645)
Purchases of held-to-maturity securities			(1,210)
Purchases of office properties and equipment	(2,041)	(1,562)	(1,763)
Investment in bank owned life insurance		(3,757)	(1,500)
Proceed from insurance death benefit		728	
Net cash paid in Andres O Neil & Lowe acquisition		(1,500)	
Proceeds from FHLB stock redemption	357	364	
Net cash paid in Payak-Dubbs acquisition	(3,914)		
Purchase of portfolio mortgage loans	(25,842)		
Proceeds from sale of non-mortgage loans	9,212	13,949	8,714
Net decrease (increase) in loans receivable	31,137	53,767	(35,598)
Net cash provided by (used) in investing activities	(40,949)	44,356	(43,371)

**Table of Contents**

## FIRST DEFIANCE FINANCIAL CORP.

## Consolidated Statements of Cash Flows (continued)

(Amounts in Thousands)

	Years Ended December 31		
	2011	2010	2009
<b>Financing Activities</b>			
Net increase (decrease) in deposits	21,314	(4,468)	110,577
Repayment of Federal Home Loan Bank long-term advances	(35,044)	(30,042)	(25,040)
Net decrease in Federal Home Loan Bank short-term advances			(9,100)
Proceeds from Federal Home Loan Bank long-term advances			25,000
Increase (decrease) in securities sold under repurchase agreements	4,139	7,849	(1,056)
Cash dividends paid on common stock	(481)		(3,776)
Cash dividends paid on preferred stock	(1,850)	(1,850)	(1,747)
Net cash received from common stock issuance	19,859		
Proceeds from exercise of stock options	11	3	5
Proceeds from treasury stock purchases	29		
Net cash (used) provided by financing activities	7,977	(28,508)	94,863
Increase (decrease) in cash and cash equivalents	5,767	48,048	74,964
Cash and cash equivalents at beginning of period	169,164	121,116	46,152
Cash and cash equivalents at end of period	\$ 174,931	\$ 169,164	\$ 121,116
<b>Supplemental cash flow information:</b>			
Interest paid	\$ 17,464	\$ 26,212	\$ 34,038
Income taxes paid	\$ 4,875	\$ 5,800	\$ 8,800
Transfers from loans to other real estate owned and other assets held for sale	\$ 4,614	\$ 12,147	\$ 14,930
Transfer from loans held for sale to loans	\$ 7,596	\$	\$
Transfers from premises and equipment to other real estate owned and other assets held for sale	\$	\$	\$ 300

*See accompanying notes.*

## **Table of Contents**

### **Notes to the Consolidated Financial Statements**

#### **1. Basis of Presentation**

First Defiance Financial Corp. (First Defiance or the Company) is a unitary thrift holding company that conducts business through its two wholly owned subsidiaries, First Federal Bank of the Midwest (First Federal) and First Insurance Group of the Midwest, Inc., formerly First Insurance and Investments, Inc. (First Insurance). All significant intercompany transactions and balances are eliminated in consolidation.

First Federal is primarily engaged in attracting deposits from the general public through its offices and using those and other available sources of funds to originate loans primarily in the counties in which its offices are located. First Federal's traditional banking activities include originating and servicing residential, commercial and consumer loans and providing a broad range of depository, trust and wealth management services. First Insurance is an insurance agency that does business in the Defiance, Archbold, Bryan, Bowling Green, Maumee and Oregon, Ohio areas, offering property and casualty, and group health and life insurance products. On July 1, 2011, the Company completed its acquisition of Payak-Dubbs Insurance Agency, Inc. (PDI), an independent property and casualty insurance agency with two office locations based in Maumee, Ohio and Oregon, Ohio for a cash price of \$4.8 million. PDI was merged into First Insurance.

#### **2. Statement of Accounting Policies**

##### **Use of Estimates**

The preparation of consolidated 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 amounts reported in the consolidated financial statements and accompanying notes. Actual results could differ from those estimates. Significant areas where First Defiance uses estimates are the valuation of certain investment securities, the determination of the allowance for loan losses, the valuation of mortgage servicing rights and goodwill, the determination of unrecognized income tax benefits, and the determination of post-retirement benefits.

##### **Earnings Per Common Share**

Basic earnings per common share is computed by dividing net income applicable to common shares (net income less dividend requirements for preferred stock and accretion of preferred stock discount) by the weighted average number of shares of common stock outstanding during the period. All outstanding unvested share-based payment awards that contain rights to nonforfeitable dividends are considered participating securities for the calculation. Diluted earnings per common share include the dilutive effect of additional potential common shares issuable under stock options, warrants, restricted stock awards and stock grants. Also see Notes 5 and 20.

##### **Comprehensive Income**

Comprehensive income (loss) consists of net income and other comprehensive income (loss). Other comprehensive income includes unrealized gains and losses on available-for-sale securities and the net unrecognized actuarial losses and unrecognized prior service costs associated with the Company's Defined Benefit Postretirement Medical Plan. All items included in other comprehensive income are reported net of tax. See also Notes 3, 6 and 17.

## **Table of Contents**

### **Cash Flows**

Cash and cash equivalents include amounts due from banks and overnight investments with the Federal Home Loan Bank (FHLB) and the Federal Reserve Bank (FRB). Cash and amounts due from depository institutions include required balances on hand or on deposit at the FHLB and Federal Reserve of approximately \$1,649,000 and \$2,279,000, respectively, at December 31, 2011 to meet regulatory reserve and clearing requirements. Net cash flows are reported for customer loan and deposit transactions, interest bearing deposits in other financial institutions and repurchase agreements.

### **Investment Securities**

Management determines the appropriate classification of debt securities at the time of purchase and evaluates such designation as of each balance sheet date. Debt securities are classified as held-to-maturity when First Defiance has the positive intent and ability to hold the securities to maturity and are reported at cost, adjusted for premiums and discounts that are recognized in interest income using the interest method over the period to maturity.

Debt securities not classified as held-to-maturity and equity securities are classified as available-for-sale. Available-for-sale securities are stated at fair value, with the unrealized gains and losses, net of tax, reported in other comprehensive income (loss) until realized. Realized gains and losses are included in gains (losses) on securities or other-than-temporary impairment losses on securities. Realized gains and losses on securities sold are recognized on the trade date based on the specific identification method.

Interest income includes amortization of purchase premiums and discounts. Premiums and discounts are amortized on the level-yield method without anticipating prepayments, except for mortgage-backed securities where prepayments are expected. Securities with unrealized losses are reviewed quarterly to determine if value impairment is other than-temporary. In performing this review management considers the length of time and extent that fair value has been less than cost, the financial condition of the issuer, the impact of changes in market interest rates on market value and whether the Company intends to sell or it would be more than likely required to sell the securities prior to their anticipated recovery. If either of the criteria regarding intent or requirement to sell is met, the entire difference between amortized cost and fair value is recognized as impairment through earnings. For debt securities that do not meet the aforementioned criteria, the amount of impairment is split into two components as follows: 1) OTTI related to credit loss, which must be recognized in the income statement and 2) other-than-temporary impairment (OTTI) related to other factors, which is recognized in other comprehensive income. The credit loss is defined as the difference between the present value of the cash flows expected to be collected and the amortized cost basis. For equity securities, the entire amount of impairment is recognized through earnings.

### **FHLB Stock**

As a member of the FHLB System, First Federal is required to own stock of the FHLB of Cincinnati in an amount principally equal to 0.15% of total assets plus an amount of at least 2% but no more than 4% of its non-grandfathered mission asset activity (as defined in the FHLB's regulations). First Federal is permitted to own stock in excess of the minimum requirement. FHLB stock is a restricted equity security that does not have a readily determinable fair value and is carried at cost. It is evaluated for impairment based upon the ultimate recovery of par value. Both cash and stock dividends are reported as income. At December 31, 2011, the balance at FHLB of Cincinnati was \$19.3 million. First Federal acquired \$2.0 million of stock from the Pavilion acquisition which is held at the FHLB of Indianapolis and is required to be held for five years from the date of acquisition of March 14, 2008. The balance of this stock was \$1.3 million at December 31, 2011.

## **Table of Contents**

### **Loans Receivable**

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are reported at the principal amount outstanding, net of deferred loan fees and costs, purchase premiums and discounts and the allowance for loan losses. Deferred fees net of deferred incremental loan origination costs, are amortized to interest income generally over the contractual life of the loan using the interest method without anticipating prepayments. The recorded investment in loans includes accrued interest receivable and net deferred fees and costs and undisbursed loan amounts.

Mortgage loans originated and intended for sale in the secondary market are classified as loans held for sale and are carried at the lower of aggregate cost or fair value, as determined by outstanding commitments from investors. Net unrealized losses, if any, are recorded as a valuation allowance and charged to earnings. Mortgage loans held for sale are generally sold with servicing rights retained. The carrying value of mortgage loans sold is reduced by the amount allocated to the servicing right. Gains or losses on sales of mortgage loans are based on the difference between the selling price and the carrying value of the related loan sold.

During 2011 and 2010, the Company realized losses totaling \$413,000 and \$477,000 pertaining to loans sold to Fannie Mae and Freddie Mac but was returned due to underwriting issues. Repurchase losses are recognized when the Company determines they are probable and estimable. No amount was accrued at December 31, 2011 and 2010 for such losses.

Interest receivable is accrued on loans and credited to income as earned. The accrual of interest on loans 90 days delinquent or impaired is discontinued when, in management's opinion, the borrower may be unable to meet payments as they become due. For these loans, interest accrual is only to the extent cash payments are received. The accrual of interest on these loans is generally resumed after a pattern of repayment has been established and the collection of principal and interest is reasonably assured.

### **Acquired Loans**

Valuation allowances for all acquired loans subject to FASB ASC Topic 310 reflect only those losses incurred after acquisition—that is, the present value of cash flows expected at acquisition that are not expected to be collected.

The Company acquires loans individually and in groups or portfolios. At acquisition, the Company reviews each loan to determine whether there is evidence of deterioration of credit quality since origination and if it is probable that it will be unable to collect all amounts due according to the loan's contractual terms. If both conditions exist, the Company determines whether each such loan is to be accounted for individually or whether such loans will be assembled into pools of loans based on common risk characteristics (credit score, loan type and date of origination). The Company considers expected prepayments, and estimates the amount and timing of undiscounted expected principal, interest, and other cash flows (expected at acquisition) for each loan and subsequently aggregated pool of loans.

The Company determines the excess of the loan's or pool's scheduled contractual principal and contractual interest payments over all cash flows expected at acquisition as an amount that should not be accreted (nonaccretable difference). The remaining amount representing the excess of the loan's cash flows expected to be collected over the amount paid is accreted into interest income over the remaining life of the loan or pool (accretable yield).

## **Table of Contents**

Over the life of the loan or pool, the Company continues to estimate cash flows expected to be collected, and evaluates whether the present value of its loans determined using the effective interest rates has decreased and, if so, recognizes a loss. The present value of any subsequent increase in the loan's or pool's actual cash flows or cash flows expected to be collected is used first to reverse any existing valuation allowance for that loan or pool. For any remaining increases in cash flows expected to be collected, the Company adjusts the amount of accretable yield recognized on a prospective basis over the loan's or pool's remaining life.

### **Allowance for Loan Losses**

The allowance for loan losses is maintained at a level believed adequate by management to absorb probable incurred losses in the loan portfolio and is based on the size and current risk characteristics of the loan portfolio, an assessment of individual problem loans, actual loss experience, current economic events in specific industries and geographical areas and other pertinent factors, including general economic conditions. Determination of the allowance is inherently subjective as it requires significant estimates, including the amounts and timing of expected future cash flows on impaired loans, estimated losses on pools of homogeneous loans based on historical loss experience and consideration of economic trends, all of which may be susceptible to significant change. Allocations of the allowance may be made for specific loans, but the entire allowance is available for any loan that, in management's judgment, should be charged off.

Loan losses are charged off against the allowance when in management's estimation it is unlikely that the loan will be collected, while recoveries of amounts previously charged off are credited to the allowance. A provision for loan loss is charged to operations based on management's periodic evaluation of the factors previously mentioned, as well as other pertinent factors in order to maintain the allowance for loan losses at the level deemed adequate by management. The determination of whether a loan is considered past due or delinquent is based on the contractual payment terms.

The allowance consists of specific and general components. The specific component relates to loans that are individually classified as impaired.

A loan is impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loans agreement. Loans, for which terms have been modified and for which the borrower is experiencing financial difficulties, are considered troubled debt restructurings and classified as impaired. Generally, loans classified as a troubled debt restructuring are reviewed and an allowance for loan loss is established for any collateral shortfall. In some cases where there is an interest rate reduction, a cash flow analysis of the net present value is performed and an allowance may be established based on the outcome of that analysis. All modifications are reviewed by the Bank's senior loan committee to determine whether or not the modification constitutes a troubled debt restructure. Commercial and commercial real estate loans are individually evaluated for impairment. If a loan is impaired, a portion of the allowance is allocated so that the loan is reported net at the present value of estimated future cash flows using the loan's existing rate or at the fair value of collateral if repayment is expected solely from the collateral. Large groups of smaller balance homogeneous loans, such as consumer and residential real estate loans, are collectively evaluated for impairment, and accordingly, they are not separately identified for impairment disclosures.

The general component covers non-impaired loans and is based on historical loss experience adjusted for current factors. The historical loss experience is determined by portfolio segment and is based on the actual loss history experienced by the Company over the most recent two years. Loss experience is adjusted for other economic factors based on the identified risks, credit related or trends present for each portfolio segment. These economic factors include consideration of the following: levels of and trends in



## **Table of Contents**

delinquencies and impaired loans; levels of and trends in charge-offs and recoveries; trends in volume and terms of loans; effects of any changes in risk selection and underwriting standards; other changes in lending policies, procedures, and practices; experience, ability, and depth of lending management and other relevant staff; national and local economic trends and conditions; industry conditions; and effects of changes in credit concentrations. The following portfolio segments have been identified: commercial real estate (consisting of multi-family residential and non-residential), commercial, consumer, residential real estate, construction, consumer, and home equity and improvement.

### **Servicing Rights**

Servicing rights are recognized separately when they are acquired through sales of loans. Servicing rights are initially recorded at fair value with the income statement effect recorded in gains on sales of loans. Fair value is based on market prices for comparable mortgage servicing contracts, when available, or alternatively, is based on a valuation model that calculates the present value of estimated future net servicing income. The valuation model incorporates assumptions that market participants would use in estimating future net servicing income, such as the cost to service, the discount rate, the custodial earnings rate, an inflation rate, ancillary income, prepayment speeds and default rates and losses. The Company compares the valuation model inputs and results to published industry data in order to validate the model results and assumptions. All classes of servicing assets are subsequently measured using the amortization method which requires servicing rights to be amortized into non-interest income in proportion to, and over the period of, the estimated future net servicing income of the underlying loans.

Servicing assets are evaluated for impairment based upon the fair value of the rights as compared to carrying amount. Impairment is determined by stratifying rights into groupings based on predominant risk characteristics, such as interest rate, loan type and investor type. Impairment is recognized through a valuation allowance for an individual grouping, to the extent that fair value is less than the carrying amount. If the Company later determines that all or a portion of the impairment no longer exists for a particular grouping, a reduction of the allowance may be recorded as an increase to income. Changes in valuation allowances are reported with mortgage banking income on the income statement. The fair values of servicing rights are subject to significant fluctuations as a result of changes in estimated and actual prepayment speeds and default rates and losses.

Servicing fee income, which is reported on the income statement with mortgage banking income, is recorded for fees earned for servicing loans. The fees are based on a contractual percentage of the outstanding principal, or a fixed amount per loan, and are recorded as income when earned. The amortization of mortgage servicing rights is netted against loan servicing fee income. Servicing fees, net of amortization of mortgage servicing rights (excluding valuation adjustments) totaled \$1.2 million, \$477,000 and \$(311,000) for the years ended December 31, 2011, 2010 and 2009. Late fees and ancillary fees related to loan servicing are not material. See Note 9.

### **Bank Owned Life Insurance**

The Company has purchased life insurance policies on certain key employees. Bank owned life insurance is recorded at the amount that can be realized under the insurance contract at the balance sheet date, which is the cash surrender value adjusted for other charges or other amounts due that are probable at settlement.

## **Table of Contents**

### **Premises and Equipment and Long Lived Assets**

Land is carried at cost. Premises and equipment are carried at cost less accumulated depreciation and amortization computed principally by the straight-line method over the following estimated useful lives:

Buildings and improvements	20 to 50 years
Furniture, fixtures and equipment	3 to 15 years
Long-lived assets to be held and those to be disposed of and certain intangibles are periodically evaluated for impairment. See Note 10.	

### **Goodwill and Other Intangibles**

Goodwill resulting from business combinations prior to January 1, 2009 represents the excess of the purchase price over the fair value of the net assets of businesses acquired. Goodwill resulting from business combinations after January 1, 2009, is generally determined as the excess of the fair value of the consideration transferred, plus the fair value of any noncontrolling interests in the acquiree, over the fair value of the net assets acquired and liabilities assumed as of the acquisition date. Goodwill and intangible assets acquired in a purchase business combination and determined to have an indefinite useful life are not amortized, but tested for impairment at least annually. The Company has selected November 30 as the date to perform the annual impairment test. Intangible assets with definite useful lives are amortized over their estimated useful lives to their estimated residual values. Goodwill is the only intangible asset with an indefinite life on our balance sheet.

Other intangible assets consist of core deposit and acquired customer relationship intangible assets arising from whole bank, insurance and branch acquisitions. They are initially recorded at fair value and then amortized on an accelerated basis over their estimated lives, which range from five years for non-compete agreements to 10 to 20 years for core deposit and customer relationship intangibles. See Note 11.

### **Real Estate and Other Assets Held for Sale**

Other assets held for sale are comprised of properties acquired through foreclosure proceedings or acceptance of a deed in lieu of foreclosure. These assets are initially recorded at fair value less costs to sell when acquired, establishing a new cost basis. Losses arising from the acquisition of such property are charged against the allowance for loan losses at the time of acquisition. These properties are carried at the lower of cost or fair value, less estimated costs to dispose. If fair value declines subsequent to foreclosure, the property is written down against expense. Costs after acquisition are expensed.

### **Stock Compensation Plans**

Compensation cost is recognized for stock options and restricted share awards issued to employees and directors, based on the fair value of these awards at the date of grant. A Black-Scholes model is utilized to estimate the fair value of stock options. Compensation cost is recognized over the required service period, generally defined as the vesting period. For awards with graded vesting, compensation cost is recognized on a straight-line basis over the requisite service period for the entire award. See Note 21.

### **Fair Value of Financial Instruments**

Fair values of financial instruments are estimated using relevant market information and other assumptions, as more fully disclosed in a separate note. Fair value estimates involve uncertainties and matters of significant judgment regarding interest rates, credit risk, prepayments, and other factors, especially in the absence of broad markets for particular items. Changes in assumptions or in market conditions could significantly affect the estimates.

## **Table of Contents**

### **Transfers of Financial Assets**

Transfers of financial assets are accounted for as sales, when control over the assets has been relinquished. Control over transferred assets is deemed to be surrendered when the assets have been isolated from the Company, the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets and the Company does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

### **Mortgage Banking Derivatives**

Commitments to fund mortgage loans (interest rate locks) to be sold into the secondary market and forward commitments for the future delivery of these mortgage loans are accounted for as free standing derivatives. Fair values of these mortgage derivatives are estimated based on changes in mortgage interest rates from the date the interest on the loan is locked. The Company enters into forward commitments for the future delivery of mortgage loans when interest rate locks are entered into, in order to hedge the change in interest rates resulting from its commitments to fund the loans. Changes in fair values of these derivatives are included in mortgage banking income.

### **Operating Segments**

Management considers the following factors in determining the need to disclose separate operating segments: 1) The nature of products and services, which are all financial in nature; 2) The type and class of customer for the products and services; in First Defiance's case retail customers for retail bank and insurance products and commercial customers for commercial loan, deposit, life, health and property and casualty insurance needs; 3) The methods used to distribute products or provide services; such services are delivered through banking and insurance offices and through bank and insurance customer contact representatives. Retail and commercial customers are frequently targets for both banking and insurance products; 4) The nature of the regulatory environment; both banking and insurance entities are subject to various regulatory bodies and a number of specific regulations.

Quantitative thresholds as stated in Financial Accounting Standards Board ( FASB ) Accounting Standards Codification ( ASC ) Topic 280, *Segment Reporting* are monitored. For the year ended December 31, 2011, the reported revenue for First Insurance was 7.1% of total revenue for First Defiance. Total revenue includes net interest income (before provision for loan losses) plus non-interest income. Net income for First Insurance for the year ended December 31, 2011 was 2.9% of consolidated net income. Total assets of First Insurance at December 31, 2011 were 0.7% of total assets. First Insurance does not meet any of the quantitative thresholds of FASB ASC Topic 280. Accordingly, all of the financial service operations are considered by management to be aggregated in one reportable segment.

### **Dividend Restriction**

Banking regulations require maintaining certain capital levels and may limit the dividends paid by the savings bank to the holding company. See Note 18 for further details on restrictions.

### **Loan Commitments and Related Financial Instruments**

Financial instruments include off-balance sheet credit instruments, such as commitments to make loans and commercial letters of credit, issued to meet customer financing needs. The face amount for these items represents the exposure to loss, before considering customer collateral or ability to repay. Such financial instruments are recorded when they are funded.

## **Table of Contents**

### **Loss Contingencies**

Loss contingencies, including claims and legal actions arising in the ordinary course of business, are recorded as liabilities when the likelihood of loss is probable and an amount or range of loss can be reasonably estimated. Management does not believe there are any such matters that will have a material effect on the financial statements.

### **Income Taxes**

Income tax expense is the total of the current year income tax due or refundable and the change in deferred tax assets and liabilities. Deferred tax assets and liabilities are the expected future tax amounts for the temporary differences between carrying amounts and tax bases of assets and liabilities, computed using enacted tax rates. A valuation allowance, if needed, reduces deferred tax assets to the amount expected to be realized. Realization of deferred tax assets is dependent upon the generation of a sufficient level of future taxable income and recoverable taxes paid in prior years. Although realization is not assured, management believes it is more likely than not that all of the deferred tax assets will be realized.

An effective tax rate of 35% is used to determine after-tax components of other comprehensive income (loss) included in the statements of stockholders' equity. See Note 19.

A tax position is recognized as a benefit only if it is more likely than not that the tax position would be sustained in a tax examination, with a tax examination being presumed to occur. The amount recognized is the largest amount of tax benefit that is greater than 50% likely of being realized on examination. For tax positions not meeting the more likely than not test, no tax benefit is recorded.

The Company recognizes interest and/or penalties related to income tax matters in income tax expense.

### **Retirement Plans**

Pension expense is the net of service and interest cost, return on plan assets and amortization of gains and losses not immediately recognized. Employee 401(k) plan expense is the amount of matching contributions. Deferred compensation and supplemental retirement plan expense allocates the benefits over years of service.

### **Reclassifications**

Some items in the prior year financial statements were reclassified to conform to the current presentation.

### **Accounting Standards Updates**

In April 2011, the FASB issued ASU No. 2011-02, *A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring*, updated to amend previous guidance with respect to troubled debt restructurings. This updated guidance is designed to assist creditors with determining whether or not a restructuring constitutes a troubled debt restructuring. In particular, additional guidance has been added to help creditors determine whether a concession has been granted and whether a debtor is experiencing financial difficulties. Both of these conditions are required to be met for a restructuring to

## **Table of Contents**

constitute a troubled debt restructuring. The amendments in the update are effective for the first interim period beginning on or after June 15, 2011, and should be applied retrospectively to the beginning of the annual period of adoption. The provisions of this update did not have a material impact on the Company's financial position, results of operations or cash flows.

In May 2011, the FASB issued ASU No. 2011-04, *Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*. The amendments in this ASU generally represent clarifications of Topic 820, but also include some instances where a particular principle or requirement for measuring fair value or disclosing information about fair value measurements has changed. This ASU results in common principles and requirements for measuring fair value and for disclosing information about fair value measurements in accordance with U.S. GAAP and IFRSs. The amendments in this ASU are to be applied prospectively. For public entities, the amendments are effective during interim and annual periods beginning after December 15, 2011. Early application by public entities is not permitted. The amendments of this update are not expected to have a material impact on the Company's financial position, results of operations or cash flows.

In June 2011, the FASB issued ASU No. 2011-05, *Amendments to Topic 220, Comprehensive Income*. Under the amendments in this ASU, an entity has the option to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In both choices, an entity is required to present each component of net income along with total net income, each component of other comprehensive income along with a total for other comprehensive income, and a total amount for comprehensive income. This ASU eliminates the option to present the components of other comprehensive income as part of the statement of changes in stockholders' equity. The amendments in this ASU do not change the items that must be reported in other comprehensive income or when an item of other comprehensive income must be reclassified to net income. The amendments of this ASU should be applied retrospectively. For public entities, the amendments are effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. Early adoption is permitted because compliance with the amendments is already permitted. The amendments do not require any transition disclosures. The provisions of this update are not expected to have a material impact on the Company's financial position, results of operations or cash flows.

In September 2011, the FASB issued ASU No. 2011-08, *Testing Goodwill for Impairment*. The provisions of ASU No. 2011-08 permits an entity an option to first perform a qualitative assessment to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If an entity believes, as a result of its qualitative assessment, that it is more likely than not that the fair value of a reporting unit is less than its carrying amount, the quantitative impairment test is required. Otherwise, no further impairment testing is required. ASU No. 2011-08 includes examples of events and circumstances that may indicate that a reporting unit's fair value is less than its carrying amount. The provisions of ASU No. 2011-08 are effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. Early adoption is permitted provided that the entity has not yet performed its annual impairment test for goodwill. The provisions of this update are not expected to have a material impact on the Company's financial position, results of operations or cash flows.

In December 2011, the FASB issued ASU No. 2011-12, *Comprehensive Income (Topic 220) - Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05*. ASU 2011-12 defers changes in ASU No. 2011-05 that relate to the presentation of reclassification adjustments to allow the FASB time to re-deliberate whether to require presentation of such adjustments on the face of the financial statements to show the effects of reclassifications out of accumulated other comprehensive

**Table of Contents**

income on the components of net income and other comprehensive income. ASU 2011-12 allows entities to continue to report reclassifications out of accumulated other comprehensive income consistent with the presentation requirements in effect before ASU 2011-05. All other requirements in ASU 2011-05 are not affected by ASU 2011-12. ASU 2011-12 is effective for annual and interim periods beginning after December 15, 2011 and is not expected to have a material impact on the Company's financial position, results of operations or cash flows.

**Table of Contents****3. Comprehensive Income**

Comprehensive income consists of net income and other comprehensive income (loss) ( OCI ). OCI includes unrealized gains and losses on securities available-for-sale and the net unrecognized actuarial losses and unrecognized prior services costs associated with the Company's Defined Benefit Postretirement Medical Plan. All items reported in OCI are reported net of tax. Following is a summary of OCI for the years ended December 31, 2011, 2010 and 2009:

	<b>For the Year Ended December 31</b>		
	<b>2011</b>	<b>2010</b>	<b>2009</b>
	<b>(In Thousands)</b>		
Net income	<b>\$ 15,534</b>	<b>\$ 8,108</b>	<b>\$ 7,194</b>
Change in securities available-for-sale (AFS):			
Unrealized holding gains (losses) on available-for-sale securities arising during the period	<b>7,404</b>	<b>(1,010)</b>	<b>(1,244)</b>
Reclassification adjustment for (gains) losses realized in income	<b>(218)</b>	<b>8</b>	<b>(284)</b>
Other-than-temporary impairment losses on AFS securities realized in income	<b>2</b>	<b>331</b>	<b>3,940</b>
Net unrealized gains (losses)	<b>7,188</b>	<b>(671)</b>	<b>2,412</b>
Income tax effect	<b>(2,516)</b>	<b>235</b>	<b>(844)</b>
Net of tax amount	<b>4,672</b>	<b>(436)</b>	<b>1,568</b>
Change in unrealized gain on postretirement benefit:			
Net gain (loss) on defined benefit postretirement medical plan realized during the period	<b>(537)</b>	<b>349</b>	<b>218</b>
Net amortization and deferral	<b>25</b>	<b>39</b>	<b>56</b>
Net gain (loss) activity during the period	<b>(512)</b>	<b>388</b>	<b>274</b>
Income tax effect	<b>179</b>	<b>(136)</b>	<b>(96)</b>
Net of tax amount	<b>(333)</b>	<b>252</b>	<b>178</b>
Total other comprehensive income (loss)	<b>4,339</b>	<b>(184)</b>	<b>1,746</b>
Comprehensive income	<b>\$ 19,873</b>	<b>\$ 7,924</b>	<b>\$ 8,940</b>

The following table summarizes the changes within each classification of accumulated other comprehensive income for the years ended December 31, 2011 and 2010:

	<b>Unrealized gains (losses) on available for sale securities</b>	<b>Postretirement Benefit (In Thousands)</b>	<b>Accumulated other comprehensive income (loss), net</b>
Balance at December 31, 2010	<b>\$ 32</b>	<b>\$ (374)</b>	<b>\$ (342)</b>
Other comprehensive income (loss), net	<b>4,672</b>	<b>(333)</b>	<b>4,339</b>
Balance at December 31, 2011	<b>\$ 4,704</b>	<b>\$ (707)</b>	<b>\$ 3,997</b>





**Table of Contents**

	Unrealized gains (losses) on available for sale securities	Postretirement Benefit (In Thousands)	Accumulated other comprehensive income (loss), net
Balance at December 31, 2009	\$ 468	\$ (626)	\$ (158)
Other comprehensive income (loss), net	(436)	252	(184)
Balance at December 31, 2010	\$ 32	\$ (374)	\$ (342)

**4. Acquisitions**

On July 1, 2011, First Defiance acquired PDI, an insurance agency headquartered in Maumee and Oregon, Ohio for a cash purchase price \$4.8 million and future consideration to be paid in cash in 2012 and 2013. As of December 31, 2011, management has reported goodwill of approximately \$4.0 million and identifiable intangible assets of \$1.5 million consisting of customer relationship intangible of \$947,000 and a non-compete intangible of \$518,000. A contingent payable of \$626,000 was also recorded in the transaction. The Company accounted for the transaction under the acquisition method of accounting which requires purchased assets and assumed liabilities to be recorded at their respective acquisition date fair value. Disclosure of pro forma results of this acquisition is not material to the Company's consolidated financial statements.

On May 10, 2010, First Defiance acquired a group medical benefits line of business from Andres O. Neil & Lowe Insurance Agency ( AOL ) for a cash purchase price of \$1.5 million and future consideration to be paid in cash in 2010, 2011 and 2012. The acquisition resulted in goodwill of \$971,200 and identifiable intangible assets of \$735,800 consisting of a customer relationship intangible of \$597,800 and a non-compete intangible of \$138,000 and a recorded contingent payable of \$207,000. Disclosure of pro forma results of this acquisition is not material to the Company's consolidated financial statements.

**Table of Contents****5. Earnings Per Common Share**

The following table sets forth the computation of basic and diluted earnings per common share:

	2011 (In Thousands, Except Per Share Amounts)	2010	2009
Numerator for basic and diluted earnings per common share-net income applicable to common shares	\$ 13,506	\$ 6,088	\$ 5,184
Denominator:			
Denominator for basic earnings per common share-weighted-average common shares, including participating securities	9,371	8,118	8,117
Effect of dilutive securities:			
Employee stock options	15	1	1
Warrants	154	34	78
Dilutive potential common shares	169	35	79
Denominator for diluted earnings per common share	9,540	8,153	8,196
Basic earnings per common share	\$ 1.44	\$ .75	\$ .64
Diluted earnings per common share	\$ 1.42	\$ .75	\$ .63

Shares under option of 255,700 in 2011, 363,050 in 2010 and 412,150 in 2009 were excluded from the diluted earnings per common share calculation as they were anti-dilutive.

**Table of Contents****6. Investment Securities**

The following tables summarize the amortized cost and fair value of available-for-sale securities and held-to-maturity investment securities portfolio at December 31, 2011 and 2010 and the corresponding amounts of gross unrealized gains and losses recognized in accumulated other comprehensive income (loss) were as follows:

	Amortized Cost	Gross Unrealized Gains <i>(In Thousands)</i>	Gross Unrealized Losses	Fair Value
<b><u>2011</u></b>				
Available-for-sale				
Obligations of U.S. government corporations and agencies	\$ 16,989	\$ 96	\$	\$ 17,085
U.S. treasury bonds	2,000	10		2,010
Mortgage-backed securities - residential REMICs	68,400	2,318	(2)	70,716
	2,863	31		2,894
Collateralized mortgage obligations	57,083	1,926		59,009
Trust preferred stock and preferred stock	3,790	73	(2,413)	1,450
Corporate bonds	8,629		(377)	8,252
Obligations of state and political subdivisions	65,928	5,580	(5)	71,503
<b>Total Available-for-Sale</b>	<b>\$ 225,682</b>	<b>\$ 10,034</b>	<b>\$ (2,797)</b>	<b>\$ 232,919</b>
Held-to-Maturity				
FHLMC certificates	\$ 82	\$ 1	\$	\$ 83
FNMA certificates	199	4		203
GNMA certificates	72	3		75
Obligations of states and political subdivisions	308	3		311
<b>Total Held-to-Maturity</b>	<b>\$ 661</b>	<b>\$ 11</b>	<b>\$</b>	<b>\$ 672</b>

**Table of Contents**

	Amortized Cost	Gross Unrealized Gains (In Thousands)	Gross Unrealized Losses	Fair Value
<b>2010</b>				
Available-for-sale				
Obligations of U.S. government corporations and agencies	\$ 11,980	\$ 80	\$ (75)	\$ 11,985
Mortgage-backed securities - residential REMICs	39,561	1,244	(229)	40,576
	3,378	163		3,541
Collateralized mortgage obligations	49,862	1,364	(169)	51,057
Trust preferred stock and preferred stock	3,787	13	(2,254)	1,546
Corporate bonds	3,782	15		3,797
Obligations of state and political subdivisions	52,853	779	(882)	52,750
Total Available-for-Sale	\$ 165,203	\$ 3,658	\$ (3,609)	\$ 165,252
Held-to-Maturity				
FHLMC certificates	\$ 95	\$ 7	\$	\$ 102
FNMA certificates	259	6		265
GNMA certificates	86	3		89
Obligations of states and political subdivisions	399	10		409
Total Held-to-Maturity	\$ 839	\$ 26	\$	\$ 865

The amortized cost and fair value of the investment securities portfolio at December 31, 2011 and 2010 are shown below by contractual maturity. Expected maturities will differ from contractual maturities if borrowers have the right to call or prepay obligations with or without call or prepayment penalties. For purposes of the maturity tables below, mortgage-backed securities, collateralized mortgage obligations and REMICs, which are not due at a single maturity date, have not been allocated over maturity groupings.

	Available-for-Sale		Held-to-Maturity	
	Amortized Cost	Fair Value (In Thousands)	Amortized Cost	Fair Value
<b>2011</b>				
Due in one year or less	\$ 1,611	\$ 1,629	\$ 60	\$ 63
Due after one year through five years	12,719	12,461		
Due after five years through ten years	33,869	35,633	248	248
Due after ten years	49,137	50,577		
MBS/CMO/REMIC	128,346	132,619	353	361
	\$ 225,682	\$ 232,919	\$ 661	\$ 672

**Table of Contents**

	Available-for-Sale		Held-to-Maturity	
	Amortized Cost	Fair Value (In Thousands)	Amortized Cost	Fair Value
<b>2010</b>				
Due in one year or less	\$ 2,937	\$ 2,970	\$ 60	\$ 63
Due after one year through five years	5,116	5,204	60	67
Due after five years through ten years	18,714	19,008	279	279
Due after ten years	45,635	42,896		
MBS/CMO/REMIC	92,801	95,174	440	456
	<b>\$ 165,203</b>	<b>\$ 165,252</b>	<b>\$ 839</b>	<b>\$ 865</b>

Securities pledged at year-end 2011 and 2010 had a carrying amount of \$144.1 million and \$123.8 million and were pledged to secure public deposits, securities sold under repurchase agreements and FHLB advances.

As of December 31, 2011, the Company's investment portfolio consisted of 367 securities, 16 of which were in an unrealized loss position. The Company does not hold any single security that is greater than 10% of the Company's equity at December 31, 2011.

The following table summarizes First Defiance's securities that were in an unrealized loss position at December 31, 2011 and December 31, 2010:

	Duration of Unrealized Loss Position				Total	
	Less than 12 Months Fair Value	Gross Unrealized Loss	12 Months or Longer Fair Value	Gross Unrealized Loss	Fair Value	Unrealized Losses
						(In Thousands)
<b>At December 31, 2011</b>						
Available-for-sale securities:						
Mortgage-backed securities - residential	\$ 2,030	\$ (2)	\$	\$	\$ 2,030	\$ (2)
Obligations of state and political subdivisions			746	(5)	746	(5)
Trust preferred stock and preferred stock			1,342	(2,413)	1,342	(2,413)
Corporate bonds	8,252	(377)			8,252	(377)
Total temporarily impaired securities	\$ 10,282	\$ (379)	\$ 2,088	\$ (2,418)	\$ 12,370	\$ (2,797)

**At December 31, 2010**

Available-for-sale securities:						
Obligations of U.S. govt. corps. and agencies	\$ 3,925	\$ (75)	\$	\$	\$ 3,925	\$ (75)
Mortgage-backed securities - residential	11,876	(229)			11,876	(229)
Collateralized mortgage obligations and REMICs	6,011	(169)			6,011	(169)
Obligations of state and political subdivisions	21,431	(729)	1,116	(153)	22,547	(882)
Trust preferred stock and preferred stock			1,498	(2,254)	1,498	(2,254)
Total temporarily impaired securities	\$ 43,243	\$ (1,202)	\$ 2,614	\$ (2,407)	\$ 45,857	\$ (3,609)

With the exception of Trust Preferred Stock, the above securities all have fixed interest rates, and all securities have defined maturities. Their fair value is sensitive to movements in market interest rates.

## **Table of Contents**

First Defiance has the ability and intent to hold these investments for a time necessary to recover the amortized cost without impacting its liquidity position and it is not more than likely that the Company will be required to sell the investments before anticipated recovery.

Realized gains from the sales and calls of investment securities totaled \$218,000 (\$142,000 after tax) in 2011 while there were realized losses of \$(8,000) and gains of \$284,000 (\$(5,000) and \$185,000 after tax) in 2010 and 2009, respectively.

Management evaluates securities for other-than-temporary impairment ( OTTI ) at least on a quarterly basis, and more frequent when economic or market conditions warrant such an evaluation. The investment portfolio is evaluated for OTTI by segregating the portfolio into two general segments. Investment securities classified as available for sale or held-to-maturity are generally evaluated for OTTI under FASB ASC Topic 320. Certain collateralized debt obligations ( CDOs ) are evaluated for OTTI under FASB ASC Topic 325, *Investment Other*.

When OTTI occurs under either model, the amount of the OTTI recognized in earnings depends on whether an entity intends to sell the security or more likely than not will be required to sell the security before recovery of its amortized cost basis less any current period credit loss. If an entity intends to sell or more likely than not will be required to sell the security before recovery of its amortized cost basis less any current period credit loss, the OTTI shall be recognized in earnings equal to the entire difference between the investment's amortized cost basis and its fair value at the balance sheet date. If an entity does not intend to sell the security and it is not more likely than not that the entity will be required to sell the security before recovery of its amortized cost basis less any current period loss, the OTTI shall be separated into the amount representing the credit loss and the amount related to all other factors. The amount of OTTI related to the credit loss is determined based on the present value of cash flows expected to be collected compared to the book value of the security and is recognized in earnings. The amount of OTTI related to other factors shall be recognized in other comprehensive income, net of applicable taxes. The previous amortized cost basis less the OTTI recognized in earnings shall become the new amortized cost basis of the investment.

In 2011, management determined that one CDO had OTTI resulting in a write-down of \$2,200 (\$1,400 after tax). In 2010, management determined OTTI on three CDOs resulting in a write-down of \$214,000 (\$139,000 after tax). Also in 2010, management deemed it necessary based on the current economic conditions, to further write-down the perpetual preferred stock of Fannie Mae and Freddie Mac which resulted in a permanent write-down of \$117,000 (\$76,000 after tax). In 2009, management determined OTTI on nine CDOs resulting in a write-down of \$3.9 million.

The Company held nine CDOs at December 31, 2011. Four of those CDOs were written down in full prior to January 1, 2010. The remaining five CDOs have a total amortized cost of \$3.8 million at December 31, 2011. Of these, three, with a total amortized cost of \$1.8 million, were identified as OTTI in prior periods. The final two CDOs, with a total amortized cost of \$2.0 million, continue to pay principal and interest payments in accordance with the contractual terms of the securities and no credit loss impairment has been identified in management's analysis. Therefore, these two CDO investments have not been deemed by management to be OTTI.

Given the conditions in the debt markets today and the absence of observable transactions in the secondary and new issue markets, the Company's CDOs will be classified within Level 3 of the fair value hierarchy because management determined that significant adjustments were required to determine fair value at the measurement date.

## **Table of Contents**

As required under FASB ASC Topic 320, declines in the fair value of held-to-maturity and available-for-sale securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses to the extent the impairment is related to credit losses.

The Company's CDO valuations were supported by analysis prepared by an independent third party. Their approach to determining fair value involved several steps: 1) detailed credit and structural evaluation of each piece of collateral in the CDO; 2) collateral performance projections for each piece of collateral in the CDO (default, recovery and prepayment/amortization probabilities) and 3) discounted cash flow modeling.

### **Trust Preferred CDOs Discount Rate Methodology**

First Defiance uses market-based yield indicators as a baseline for determining appropriate discount rates, and then adjusts the resulting discount rates on the basis of its credit and structural analysis of specific CDO instruments. The primary focus is on the returns a fixed income investor would require in order to allocate capital on a risk adjusted basis. There is currently no active market for trust preferred CDOs, however, First Defiance looks principally to market yields for stand-alone trust preferred securities issued by banks, thrifts and insurance companies for which there is an active and liquid market. The next step is to make a series of adjustments to reflect the differences that nevertheless exist between these products (both credit and structural) and, most importantly, to reflect idiosyncratic credit performance differences (both actual and projected) between these products and the underlying collateral in the specific CDOs. Importantly, as part of the analysis described above, First Defiance considers the fact that structured instruments frequently exhibit leverage not present in stand-alone instruments, and makes adjustments as necessary to reflect this additional risk.

Fundamental to this evaluation is an assessment of the likelihood of CDO coverage test failures that would have the effect of diverting cash flow away from the relevant CDO bond for some period of time. Generally speaking, the Company adjusts indicative credit spreads upwards in the case of CDOs that have relatively weaker collateral and/or less cushion with respect to overcollateralization and interest coverage test ratios and downwards if the reverse is true. This aspect of the Company's discount rate methodology is important because there is frequently a great difference in the risks present in CDO instruments that are otherwise very similar (i.e. CDOs with the same basic type of collateral, the same manager, the same vintage, etc., may exhibit vastly different performance characteristics). With respect to this last point, First Defiance notes that given today's credit environment, characterized by high default and deferral rates, it is typically the case that deal-specific credit performance (determined on the basis of the credit characteristics of remaining collateral) is the best indicator of what a willing market participant would pay for an instrument.

The Company uses the same methodology for all of its CDOs and believes its valuation methodology is appropriate for all of its CDOs in accordance with FASB ASC Topic 320 as well as other related guidance.

The default and recovery probabilities for each piece of collateral were formed based on the evaluation of the collateral credit and a review of historical industry default data and current/near-term operating conditions. For collateral that has already deferred, the Company assumed a recovery of 10% of par for banks, thrifts or other depository institutions, and 15% for insurance companies. Although there is a possibility that the deferring collateral will become current at some point in the future, First Defiance has conservatively assumed that it will continue to defer and gradually will default.

## Table of Contents

The following table details the seven securities with OTTI, their lowest credit rating at December 31, 2011 and the related credit losses recognized in earnings for the four quarters ended March 31, 2011, June 30, 2011, September 30, 2011 and December 31, 2011 (In Thousands):

	Preferred Term VI Rated Ca	TPREF Funding II Rated Caa3	Alesco VIII Rated Ca	Preferred Term Sec XXVII Rated C	Trapeza CDO I Rated Ca	Alesco Preferred Funding VIII Not Rated	Alesco Preferred Funding IX Not Rated	Total
Amount of OTTI related to credit loss at January 1, 2011	\$ 80	\$ 318	\$ 1,000	\$ 76	\$ 857	\$ 453	\$ 465	\$ 3,249
Addition Qtr 1				2				2
Amount of OTTI related to credit loss at March 31, 2011	\$ 80	\$ 318	\$ 1,000	\$ 78	\$ 857	\$ 453	\$ 465	\$ 3,251
Addition Qtr 2								
Amount of OTTI related to credit loss at June 30, 2011	\$ 80	\$ 318	\$ 1,000	\$ 78	\$ 857	\$ 453	\$ 465	\$ 3,251
Addition Qtr 3								
Amount of OTTI related to credit loss at September 30, 2011	\$ 80	\$ 318	\$ 1,000	\$ 78	\$ 857	\$ 453	\$ 465	\$ 3,251
Addition Qtr 4	0	0	0	0	0	0	0	0
Amount of OTTI related to credit loss at December 31, 2011	\$ 80	\$ 318	\$ 1,000	\$ 78	\$ 857	\$ 453	\$ 465	\$ 3,251

The amount of OTTI recognized in accumulated other comprehensive income ( AOCI ) was \$847,000 for the above seven securities at December 31, 2011. There was \$820,000 recognized in accumulated other comprehensive income at December 31, 2010.



## Table of Contents

The following table provides additional information related to the five CDO investments for which a balance remains as of December 31, 2011 (dollars in thousands):

CDO	Class	Amortized Cost	Fair Value	Unrealized Loss	OTTI Losses 2011	Lowest Rating	Current Number of Banks and Insurance Companies	Actual Deferrals and Defaults as a % of Current Collateral	Expected Deferrals and Defaults as a % of Remaining Performing Collateral	Excess Sub-ordination as a % of Current Performing Collateral
Preferred Term VI	Mezz	\$ 185	\$ 52	\$ 133	\$ 0	Ca	5	64.28%	%	%
TPREF Funding II	B	677	235	442	0	Caa3	17	38.81%	19.23%	%
I-Preferred Term Sec I	B-1	1,000	455	545	0	CCC	15	16.80%	12.94%	27.68%
Dekania II CDO	C-1	990	425	565	0	CCC	34	%	12.09%	33.17%
Preferred Term Sec XXVII	C-1	903	175	728	2	C	33	28.14%	24.36%	%
Total		\$ 3,755	\$ 1,342	\$ 2,413	\$ 2					

The increase in OTTI in 2011 was the result of a slight deterioration in the performance of the underlying collateral. Specifically, depreciation was driven by both realized credit events (i.e. defaults and deferrals) and weakening credit fundamentals in some of the performing collateral, which led to an increased probability of default going forward. Excluding the Preferred Term VI, the Company's assumed average lifetime default rate declined to 28.3% at the end of 2011 from 36.1% at the end of 2010.

The table below presents a roll-forward of the credit losses relating to debt securities recognized in earnings for the years ended December 31, 2011, 2010 and 2009 (in thousands):

	2011	2010	2009
Beginning balance, January 1	\$ 3,249	\$ 5,296	\$ 1,356
Additions for amounts related to credit loss for which an OTTI was not previously recognized		76	3,521
Reductions for amounts realized for securities sold during the period		(2,261)	
Reductions for amounts related to securities for which the Company intends to sell or that it will be more likely than not that the Company will be required to sell prior to recovery of amortized cost basis			
Reductions for increase in cash flows expected to be collected that are Recognized over the remaining life of the security			
Increases to the amount related to the credit loss for which Other-than-temporary was previously recognized	2	138	419
Ending balance, December 31	\$ 3,251	\$ 3,249	\$ 5,296

**Table of Contents**

The proceeds from sales and calls of securities and the associated gains are listed below:

	2011	2010	2009
	<i>(In Thousands)</i>		
Proceeds	<b>\$ 8,719</b>	\$ 448	\$ 6,383
Gross realized gains on sales	<b>215</b>		284
Gross realized losses on sales		(11)	

The Company also recognized gross gains of \$3,000, \$3,000 and \$0 on calls during 2011, 2010 and 2009, respectively.

**7. Commitments and Contingent Liabilities****Loan Commitments**

Loan commitments are made to accommodate the financial needs of First Federal's customers; however, there are no long-term, fixed-rate loan commitments that result in market risk. Standby letters of credit commit the Company to make payments on behalf of customers when certain specified future events occur. They primarily are issued to facilitate customers' trade transactions.

Both arrangements have credit risk, essentially the same as that involved in extending loans to customers, and are subject to the Company's normal credit policies. Collateral (e.g., securities, receivables, inventory and equipment) is obtained based on management's credit assessment of the customer.

The Company's maximum obligation to extend credit for loan commitments (unfunded loans and unused lines of credit) and standby letters of credit outstanding on December 31 was as follows (in thousands):

	2011		2010	
	Fixed Rate	Variable Rate	Fixed Rate	Variable Rate
Commitments to make loans	<b>\$ 38,399</b>	<b>\$ 47,037</b>	\$ 26,382	\$ 48,801
Unused lines of credit	<b>24,943</b>	<b>184,446</b>	34,735	193,092
Standby letters of credit	<b>4,600</b>	<b>21,507</b>		21,533
Total	<b>\$ 67,942</b>	<b>\$ 252,990</b>	\$ 61,117	\$ 263,426

Commitments to make loans are generally made for periods of 60 days or less. The fixed rate loan commitments have interest rates ranging from 3.00% to 13.00% and maturities ranging from less than 1 year to 30 years.

In addition to the above commitments, at December 31, 2011 First Defiance had commitments to sell \$34.5 million of loans to Freddie Mac, Fannie Mae, Federal Home Loan Bank of Cincinnati or BB&T Mortgage.

## Table of Contents

### 8. Loans Receivable

Loans receivable consist of the following at December 31:

	December 31	
	2011	2010
	(In Thousands)	
Real estate loans:		
Secured by 1-4 family residential	\$ 203,401	\$ 205,938
Secured by multi-family residential	126,246	120,534
Secured by non-residential real estate	649,746	646,478
Construction	31,552	30,340
	1,010,945	1,003,290
Other loans:		
Commercial	349,053	369,959
Home equity and improvement	122,143	133,593
Consumer Finance	18,887	22,848
	490,083	526,400
Total loans	1,501,028	1,529,690
Deduct:		
Undisbursed loan funds	(13,243)	(9,267)
Net deferred loan origination fees and costs	(709)	(920)
Allowance for loan losses	(33,254)	(41,080)
Totals	\$ 1,453,822	\$ 1,478,423

Changes in the allowance for loan losses were as follows:

	Years Ended December 31		
	2011	2010	2009
	(In Thousands)		
Allowance at beginning of year	\$ 41,080	\$ 36,547	\$ 24,592
Provision for credit losses	12,434	23,177	23,232
Charge-offs	(21,448)	(19,328)	(11,826)
Recoveries	1,188	684	549
Net charge-offs	(20,260)	(18,644)	(11,277)
Ending allowance	\$ 33,254	\$ 41,080	\$ 36,547

## Table of Contents

The following table discloses allowance for loan loss activity for year-to-date December 31, 2011 by portfolio segment and impairment method (in thousands):

Year-to-Date December 31, 2011	1-4 Family Residential Real Estate	Construction	Multi- Family Residential Real Estate	Commercial Real Estate	Commercial	Home Equity and Improvement	Consumer	Total
Allowance for loans individually evaluated								
Beginning Specific Allocations	\$ 1,741	\$ 13	\$ 230	\$ 10,213	\$ 4,362	\$ 36	\$	\$ 16,595
Charge-Offs	(1,307)		(792)	(9,745)	(3,663)			(15,507)
Recoveries								
Provisions	220	(13)	757	4,932	270	(36)		6,130
Ending Specific Allocations	\$ 654	\$	\$ 195	\$ 5,400	\$ 969	\$	\$	\$ 7,218
Allowance for loans collectively evaluated								
Beginning General Allocations	\$ 4,215	\$ 60	\$ 1,917	\$ 9,995	\$ 6,509	\$ 1,492	\$ 297	\$ 24,485
Charge-Offs	(1,446)			(2,613)	(735)	(1,052)	(95)	(5,941)
Recoveries	127			533	393	65	70	1,188
Provisions	545	3	738	4,325	(560)	1,351	(98)	6,304
Ending General Allocations	\$ 3,441	\$ 63	\$ 2,655	\$ 12,240	\$ 5,607	\$ 1,856	\$ 174	\$ 26,036

**Table of Contents**

The following table presents the balance in the allowance for loan losses and the recorded investment in loans by portfolio segment and based on impairment method as of December 31, 2011:

(In Thousands)

	1-4 Family Residential Real Estate	Construction	Multi- Family Residential Real Estate	Commercial Real Estate	Commercial	Home Equity & Improvement	Consumer	Total
Allowance for loan losses:								
Ending allowance balance attributable to loans:								
Individually evaluated for impairment	654	\$	\$ 195	\$ 5,400	\$ 969	\$	\$	\$ 7,218
Collectively evaluated for impairment	3,441	63	2,655	12,240	5,607	1,856	174	26,036
Acquired with deteriorated credit quality								
Total ending allowance balance	\$ 4,095	\$ 63	\$ 2,850	\$ 17,640	\$ 6,576	\$ 1,856	\$ 174	\$ 33,254
Loans:								
Loans individually evaluated for impairment	\$ 4,537	\$	\$ 1,435	\$ 34,009	\$ 6,773	\$ 40	\$	\$ 46,794
Loans collectively evaluated for impairment	199,453	18,288	125,080	616,856	343,147	122,623	18,910	1,444,357
Loans acquired with deteriorated credit quality	70			825	312			1,207
Total ending loans balance	\$ 204,060	\$ 18,288	\$ 126,515	\$ 651,690	\$ 350,232	\$ 122,663	\$ 18,910	\$ 1,492,358

**Table of Contents**

The following table presents the balance in the allowance for loan losses and the recorded investment in loans by portfolio segment and based on impairment method as of December 31, 2010:

(In Thousands)

	1-4 Family Residential Real Estate	Construction	Multi- Family Residential Real Estate	Commercial Real Estate	Commercial	Home Equity & Improvement	Consumer	Total
Allowance for loan losses:								
Ending allowance balance attributable to loans:								
Individually evaluated for impairment	\$ 1,741	\$ 13	\$ 230	\$ 9,843	\$ 4,252	\$ 36	\$	\$ 16,115
Collectively evaluated for impairment	4,215	60	1,917	9,995	6,509	1,492	297	24,485
Acquired with deteriorated credit quality				370	110			480
Total ending allowance balance	\$ 5,956	\$ 73	\$ 2,147	\$ 20,208	\$ 10,871	\$ 1,528	\$ 297	\$ 41,080
Loans:								
Loans individually evaluated for impairment	\$ 8,994	\$ 64	\$ 1,333	\$ 41,290	\$ 17,189	\$ 317	\$	\$ 69,187
Loans collectively evaluated for impairment	197,296	21,007	119,444	605,882	353,386	133,881	22,942	1,453,838
Loans acquired with deteriorated credit quality	84			1,388	729			2,201
Total ending loans balance	\$ 206,374	\$ 21,071	\$ 120,777	\$ 648,560	\$ 371,304	\$ 134,198	\$ 22,942	\$ 1,525,226

**Table of Contents**

The unpaid principal balance of individually impaired loans were as follows:

	Years Ended December 31	
	2011	2010
	(In Thousands)	
Year-end loans with no allocated allowance for loan losses	\$ 29,819	\$ 26,771
Year-end loans with allocated allowance for loan losses	18,130	44,169
<b>Total</b>	<b>\$ 47,949</b>	<b>\$ 70,940</b>
Amount of the allowance for loan losses allocated	\$ 7,218	\$ 16,595

	Years Ended December 31		
	2011	2010	2009
	(In Thousands)		
Average of individually impaired loans during the year	\$ 60,999	\$ 64,429	\$ 38,860
Interest income recognized during impairment	1,701	2,237	965
Cash-basis interest income recognized	1,613	2,017	913

The following table presents the average balance, interest income recognized and cash basis income recognized on impaired loans by class of loans: (In Thousands)

	Three Months Ended December 31, 2011			Year Ended December 31, 2011		
	Average Balance	Interest Income Recognized	Cash Basis Income Recognized	Average Balance	Interest Income Recognized	Cash Basis Income Recognized
Residential Owner Occupied	\$ 2,254	\$ 15	\$ 15	\$ 2,689	\$ 68	\$ 67
Residential Non Owner Occupied	2,495	20	19	2,646	85	87
<b>Total Residential Real Estate</b>	<b>4,749</b>	<b>35</b>	<b>34</b>	<b>5,335</b>	<b>153</b>	<b>154</b>
<b>Construction</b>				<b>25</b>		
<b>Multi-Family</b>	<b>1,614</b>	<b>15</b>	<b>15</b>	<b>2,097</b>	<b>88</b>	<b>83</b>
CRE Owner Occupied	8,768	34	33	10,631	302	282
CRE Non Owner Occupied	18,246	105	101	19,351	777	724
Agriculture Land	1,569	8	8	1,932	47	47
Other CRE	8,384	1	1	7,952	54	43
<b>Total Commercial Real Estate</b>	<b>36,967</b>	<b>148</b>	<b>143</b>	<b>39,866</b>	<b>1,180</b>	<b>1,096</b>
Commercial Working Capital	2,115	5	7	3,758	74	77
Commercial Other	6,445	14	12	9,660	194	191
<b>Total Commercial</b>	<b>8,560</b>	<b>19</b>	<b>19</b>	<b>13,418</b>	<b>268</b>	<b>268</b>
<b>Consumer</b>						
<b>Home Equity and Home Improvement</b>	<b>181</b>	<b>1</b>	<b>1</b>	<b>258</b>	<b>12</b>	<b>12</b>
<b>Total Impaired Loans</b>	<b>\$ 52,071</b>	<b>\$ 218</b>	<b>\$ 212</b>	<b>\$ 60,999</b>	<b>\$ 1,701</b>	<b>\$ 1,613</b>

**Table of Contents**

The following table presents loans individually evaluated for impairment by class of loans as of December 31, 2011: *(In Thousands)*

	Unpaid Principal Balance	Recorded Investment	Allowance for Loan Losses Allocated
<b>With no allowance recorded:</b>			
Residential Owner Occupied	\$ 981	\$ 984	\$
Residential Non Owner Occupied	1,871	1,877	
<b>Total Residential Real Estate</b>	<b>2,852</b>	<b>2,861</b>	
<b>Construction</b>			
<b>Multi-Family Residential Real Estate</b>	<b>1,138</b>	<b>1,137</b>	
CRE Owner Occupied	5,868	5,879	
CRE Non Owner Occupied	8,408	8,421	
Agriculture Land	1,072	1,073	
Other CRE	5,607	5,605	
<b>Total Commercial Real Estate</b>	<b>20,955</b>	<b>20,978</b>	
Commercial Working Capital	1,391	1,393	
Commercial Other	3,444	3,453	
<b>Total Commercial</b>	<b>4,835</b>	<b>4,846</b>	
<b>Consumer</b>			
<b>Home Equity and Home Improvement</b>	<b>39</b>	<b>40</b>	
<b>Total loans with no allowance recorded</b>	<b>\$ 29,819</b>	<b>\$ 29,862</b>	<b>\$</b>
<b>With an allowance recorded:</b>			
Residential Owner Occupied	\$ 1,020	\$ 1,020	\$ 373
Residential Non Owner Occupied	726	726	281
<b>Total Residential Real Estate</b>	<b>1,746</b>	<b>1,746</b>	<b>654</b>
<b>Construction</b>			
<b>Multi-Family Residential Real Estate</b>	<b>298</b>	<b>298</b>	<b>195</b>
CRE Owner Occupied	2,284	2,284	589
CRE Non Owner Occupied	8,589	8,596	3,235
Agriculture Land	300	300	163
Other CRE	2,676	2,676	1,413
<b>Total Commercial Real Estate</b>	<b>13,849</b>	<b>13,856</b>	<b>5,400</b>
Commercial Working Capital	358	358	192
Commercial Other	1,879	1,881	777
<b>Total Commercial</b>	<b>2,237</b>	<b>2,239</b>	<b>969</b>
<b>Consumer</b>			
<b>Home Equity and Home Improvement</b>			
<b>Total loans with an allowance recorded</b>	<b>\$ 18,130</b>	<b>\$ 18,139</b>	<b>\$ 7,218</b>



**Table of Contents**

The following table presents loans individually evaluated for impairment by class of loans as of December 31, 2010: *(In Thousands)*

	Unpaid Principal Balance	Recorded Investment	Allowance for Loan Losses Allocated
<b>With no allowance recorded:</b>			
Residential Owner Occupied	\$ 1,679	\$ 1,685	\$
Residential Non Owner Occupied	3,300	3,311	
<b>Total Residential Real Estate</b>	<b>4,979</b>	<b>4,996</b>	
<b>Construction</b>			
<b>Multi-Family Residential Real Estate</b>	<b>137</b>	<b>139</b>	
CRE Owner Occupied	4,530	4,534	
CRE Non Owner Occupied	6,909	6,921	
Agriculture Land	2,394	2,401	
Other CRE	1,639	1,645	
<b>Total Commercial Real Estate</b>	<b>15,472</b>	<b>15,501</b>	
Commercial Working Capital	1,713	1,718	
Commercial Other	4,435	4,454	
<b>Total Commercial</b>	<b>6,148</b>	<b>6,172</b>	
<b>Consumer</b>			
<b>Home Equity and Home Improvement</b>	<b>35</b>	<b>35</b>	
<b>Total loans with no allowance recorded</b>	<b>\$ 26,771</b>	<b>\$ 26,843</b>	<b>\$</b>
<b>With an allowance recorded:</b>			
Residential Owner Occupied	\$ 800	\$ 803	\$ 259
Residential Non Owner Occupied	3,185	3,195	1,482
<b>Total Residential Real Estate</b>	<b>3,985</b>	<b>3,998</b>	<b>1,741</b>
<b>Construction</b>	<b>64</b>	<b>64</b>	<b>13</b>
<b>Multi-Family Residential Real Estate</b>	<b>1,193</b>	<b>1,194</b>	<b>230</b>
CRE Owner Occupied	6,436	6,451	2,860
CRE Non Owner Occupied	13,743	13,789	5,554
Agriculture Land	315	316	163
Other CRE	6,554	6,558	1,636
<b>Total Commercial Real Estate</b>	<b>27,048</b>	<b>27,114</b>	<b>10,213</b>
Commercial Working Capital	3,658	3,660	1,763
Commercial Other	7,940	7,968	2,599
<b>Total Commercial</b>	<b>11,598</b>	<b>11,628</b>	<b>4,362</b>
<b>Consumer</b>			
<b>Home Equity and Home Improvement</b>	<b>281</b>	<b>282</b>	<b>36</b>
<b>Total loans with an allowance recorded</b>	<b>\$ 44,169</b>	<b>\$ 44,280</b>	<b>\$ 16,595</b>

Impaired loans have been recognized in conformity with FASB ASC Topic 310. Loans having carrying values of \$4.6 million and \$12.1 million were transferred to real estate and other assets held for sale in 2011 and 2010, respectively.



**Table of Contents**

The unpaid principal balance of nonaccrual loans and loans past due 90 days still on accrual were as follows:

	Years Ended December 31	
	2011	2010
	(In Thousands)	
Non-accrual loans	\$ 39,328	\$ 41,040
Loans past due over 90 days still on accrual		28,017
Troubled Debt Restructurings	3,380	6,001
 Total Non Performing Loans	 \$ 42,708	 \$ 47,041
Real estate owned (REO)	3,628	9,591
 Total Non Performing Assets	 \$ 46,336	 \$ 56,632

The following table presents the aging of the recorded investment in past due loans as of December 31, 2011 by class of loans: (In Thousands)

	Current	30-59 days	60-89 days	Non Accrual	TDR	Total Past Due & TDR
Residential Owner Occupied	\$ 129,714	\$ 1,499	\$ 58	\$ 2,490	\$ 1,042	\$ 5,089
Residential Non Owner Occupied	66,673	535	50	1,397	602	2,584
<b>Total residential real estate</b>	<b>196,387</b>	<b>2,034</b>	<b>108</b>	<b>3,887</b>	<b>1,644</b>	<b>7,673</b>
<b>Construction</b>	<b>18,288</b>					
<b>Multi-Family</b>	<b>124,043</b>	<b>1,022</b>		<b>443</b>	<b>1,007</b>	<b>2,472</b>
CRE Owner Occupied	286,066	812	474	7,691	283	9,260
CRE Non Owner Occupied	237,642	681	501	10,398	89	11,669
Agriculture Land	69,515			1,275	157	1,432
Other Commercial Real Estate	27,761	3		8,342		8,345
<b>Total Commercial Real Estate</b>	<b>620,984</b>	<b>1,496</b>	<b>975</b>	<b>27,706</b>	<b>529</b>	<b>30,706</b>
Commercial Working Capital	136,365			1,410		1,410
Commercial Other	206,468	279	59	5,481	170	5,989
<b>Total Commercial</b>	<b>342,833</b>	<b>279</b>	<b>59</b>	<b>6,891</b>	<b>170</b>	<b>7,399</b>
<b>Consumer</b>	<b>18,736</b>	<b>129</b>	<b>35</b>	<b>10</b>		<b>174</b>
<b>Home Equity / Home Improvement</b>	<b>119,360</b>	<b>2,602</b>	<b>267</b>	<b>394</b>	<b>40</b>	<b>3,303</b>
 <b>Total Loans</b>	 <b>\$ 1,440,631</b>	 <b>\$ 7,562</b>	 <b>\$ 1,444</b>	 <b>\$ 39,331</b>	 <b>\$ 3,390</b>	 <b>\$ 51,727</b>

**Table of Contents**

The following table presents the aging of the recorded investment in past due loans as of December 31, 2010 by class of loans: *(In Thousands)*

	<b>Current</b>	<b>30-59 days</b>	<b>60-89 days</b>	<b>Non Accrual</b>	<b>Accruing TDR s</b>	<b>Total Past Due &amp; TDR</b>
Residential Owner Occupied	\$ 106,249	\$ 298	\$ 1,420	\$ 1,933	\$ 1,775	\$ 5,426
Residential Non Owner Occupied	86,680	842	393	5,295	1,489	8,019
<b>Total residential real estate</b>	<b>192,929</b>	<b>1,140</b>	<b>1,813</b>	<b>7,228</b>	<b>3,264</b>	<b>13,445</b>
<b>Construction</b>	<b>21,007</b>			<b>64</b>		<b>64</b>
<b>Multi-Family</b>	<b>119,606</b>	<b>257</b>	<b>228</b>	<b>686</b>		<b>1,171</b>
CRE Owner Occupied	204,590	607	718	5,764	671	7,760
CRE Non Owner Occupied	308,278	247	518	7,519	142	8,426
Agriculture Land	73,650	108	176	1,971	166	2,421
Other Commercial Real Estate	36,378		85	5,793	1,179	7,057
<b>Total Commercial Real Estate</b>	<b>622,896</b>	<b>962</b>	<b>1,497</b>	<b>21,047</b>	<b>2,158</b>	<b>25,664</b>
Commercial Working Capital	148,116		10	3,287		3,297
Commercial Other	209,328	413	1,595	8,264	291	10,563
<b>Total Commercial</b>	<b>357,444</b>	<b>413</b>	<b>1,605</b>	<b>11,551</b>	<b>291</b>	<b>13,860</b>
<b>Consumer</b>	<b>22,642</b>	<b>233</b>	<b>53</b>	<b>14</b>		<b>300</b>
<b>Home Equity / Home Improvement</b>	<b>130,281</b>	<b>2,738</b>	<b>335</b>	<b>527</b>	<b>317</b>	<b>3,917</b>
<b>Total Loans</b>	<b>\$ 1,466,805</b>	<b>\$ 5,743</b>	<b>\$ 5,531</b>	<b>\$ 41,117</b>	<b>\$ 6,030</b>	<b>\$ 58,421</b>

\* There are no loans greater than 90 days that are still accruing.

**Table of Contents****Troubled Debt Restructurings**

The Company has allocated \$1.8 million and \$2.3 million of specific reserves to customers whose loan terms have been modified in troubled debt restructurings as of December 31, 2011 and December 31, 2010. The Company has committed to lend additional amounts totaling up to \$64,000 and \$33,000 as of December 31, 2011 and December 31, 2010 to customers with outstanding loans that are classified as troubled debt restructurings.

During the twelve month period ending December 31, 2011, the terms of certain loans were modified as troubled debt restructurings. The modification of the terms of such loans included one or a combination of the following: a reduction of the stated interest rate of the loan; an extension of the maturity date at a stated rate of interest lower than the current market rate for new debt with similar risk; a permanent reduction of the recorded investment in the loan; or some other modification deeming the loan a troubled debt restructuring.

Modifications involving a reduction of the stated interest rate of the loan were for two loans. One loan was for the remaining maturity of the loan, which is in 14 years, and the other was for 6 years, after which it will convert to a market rate for the remainder of the term. There were 7 modifications involving an extension of the maturity date and those were for periods ranging from 4 months to 15 years.

The following table presents loans by class modified as troubled debt restructurings that occurred during the period ending December 31, 2011:

	Loans Modified as a TDR for the Twelve Months Ended December 31, 2011		
	Number of Loans	Recorded Investment (as of Period End)	Increase in the Allowance (as of Period End)
<b>Troubled Debt Restructurings</b>			
Residential Owner Occupied	4	\$ 250	\$ 29
Residential Non Owner Occupied	1	305	
CRE Owner Occupied	6	426	
CRE Non Owner Occupied	6	4,628	408
Commercial / Industrial	6	2,379	(916)
Home Equity / Improvement	1	22	
<b>Total</b>	<b>24</b>	<b>\$ 8,010</b>	<b>(\$ 479)</b>

The troubled debt restructurings described above decreased the allowance for loan losses by \$479,000 for the year ended December 31, 2011, after \$2.1 million of charge-offs during the year ended December 31, 2011.

There were 6 loans that defaulted during 2011 which had been modified within one year of the default date. Two of these loans totaling \$967,000 were charged off in full prior to December 2011. The remaining 4 include two residential owner occupied loans totaling \$206,000, a commercial loan totaling \$53,000, and an owner occupied CRE loan totaling \$1.5 million. The \$1.5 million owner occupied CRE loan is a golf course in which the borrower has negotiated a sale and is expected to payoff in the first quarter of 2012. A default for purposes of this disclosure is a troubled debt restructured loan in which the borrower is 90 days past due.

In order to determine whether a borrower is experiencing financial difficulty, an evaluation is performed of the probability that the borrower will be in payment default on any of its debt in the foreseeable future without the modification. This evaluation is performed in an internal loan committee meeting.

## **Table of Contents**

### **Credit Quality Indicators**

Loans are categorized into risk categories based on relevant information about the ability of borrowers to service their debt such as: current financial information, historical payment experience, credit documentation, public information, and current economic trends, among other factors. Loans are analyzed individually by classifying the loans as to credit risk. This analysis includes all non-homogeneous loans, such as commercial and commercial real estate loans and certain homogenous mortgage, home equity and consumer loans. This analysis is performed on a quarterly basis. First Defiance uses the following definitions for risk ratings:

**Special Mention.** Loans classified as special mention have a potential weakness that deserves management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or of the institution's credit position at some future date.

**Substandard.** Loans classified as substandard are inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

**Doubtful.** Loans classified as doubtful have all the weaknesses inherent in those classified as substandard, with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

**Table of Contents**

Loans not meeting the criteria above that are analyzed individually as part of the above described process are considered to be pass rated loans. As of December 31, 2011, and based on the most recent analysis performed, the risk category of loans by class of loans is as follows: *(In Thousands)*

Category	Pass	Special Mention	Substandard	Doubtful	*Not Graded	Total
Residential Owner Occupied	\$ 5,496	\$ 205	\$ 4,383	\$	\$ 124,720	\$ 134,804
Residential Non Owner Occupied	48,653	2,965	8,408		9,231	69,257
<b>Total residential real estate</b>	<b>54,149</b>	<b>3,170</b>	<b>12,791</b>		<b>133,951</b>	<b>204,061</b>
<b>Construction</b>	<b>13,417</b>		<b>127</b>		<b>4,744</b>	<b>18,288</b>
<b>Multi Family</b>	<b>117,699</b>	<b>3,519</b>	<b>4,186</b>		<b>1,111</b>	<b>126,515</b>
CRE Owner Occupied	256,861	12,058	26,323		84	295,326
CRE Non Owner Occupied	210,113	5,390	33,656		152	249,311
Agriculture Land	66,484	1,723	2,740			70,947
Other CRE	21,616	2,687	10,661		1,141	36,105
<b>Total Commercial Real Estate</b>	<b>555,074</b>	<b>21,858</b>	<b>73,380</b>		<b>1,377</b>	<b>651,689</b>
Commercial Working Capital	125,149	6,125	6,501			137,775
Commercial Other	182,964	10,328	19,165			212,457
<b>Total Commercial</b>	<b>308,113</b>	<b>16,453</b>	<b>25,666</b>			<b>350,232</b>
<b>Consumer</b>			<b>63</b>	<b>10</b>	<b>18,837</b>	<b>18,910</b>
<b>Home Equity/Improvement</b>			<b>1,734</b>		<b>120,928</b>	<b>122,662</b>
<b>Total</b>	<b>\$ 1,048,452</b>	<b>\$ 45,000</b>	<b>\$ 117,947</b>	<b>\$ 10</b>	<b>\$ 280,948</b>	<b>\$ 1,492,357</b>

\* Not Graded category include loans that do not have a credit rating as they are considered homogenous loans. Generally mortgage and consumer loans are included in this category.

**Table of Contents**

As of December 31, 2010, and based on the most recent analysis performed, the risk category of loans by class of loans is as follows: *(In Thousands)*

Category	Pass	Special Mention	Substandard	Doubtful	*Not Graded	Total
Residential Owner Occupied	\$ 6,462	\$ 1,055	\$ 5,302	\$ 794	\$ 98,063	\$ 111,676
Residential Non Owner Occupied	71,397	4,131	12,221	106	6,843	94,698
<b>Total residential real estate</b>	<b>77,859</b>	<b>5,186</b>	<b>17,523</b>	<b>900</b>	<b>104,906</b>	<b>206,374</b>
<b>Construction</b>	<b>16,401</b>	<b>244</b>	<b>64</b>		<b>4,362</b>	<b>21,071</b>
<b>Multi Family</b>	<b>111,042</b>	<b>7,089</b>	<b>787</b>	<b>661</b>	<b>1,198</b>	<b>120,777</b>
CRE Owner Occupied	174,479	12,303	25,076	295	198	212,351
CRE Non Owner Occupied	270,245	12,603	33,663		195	316,706
Agriculture Land	68,842	2,536	4,693			76,071
Other CRE	26,682	2,654	12,903		1,193	43,432
<b>Total Commercial Real Estate</b>	<b>540,248</b>	<b>30,096</b>	<b>76,335</b>	<b>295</b>	<b>1,586</b>	<b>648,560</b>
Commercial Working Capital	119,672	21,920	9,821			151,413
Commercial Other	182,070	13,969	23,852			219,891
<b>Total Commercial</b>	<b>301,742</b>	<b>35,889</b>	<b>33,673</b>			<b>371,304</b>
<b>Consumer</b>			<b>60</b>	<b>56</b>	<b>22,826</b>	<b>22,942</b>
<b>Home Equity/Improvement</b>			<b>852</b>	<b>546</b>	<b>132,800</b>	<b>134,198</b>
<b>Total</b>	<b>\$ 1,047,292</b>	<b>\$ 78,504</b>	<b>\$ 129,294</b>	<b>\$ 2,458</b>	<b>\$ 267,678</b>	<b>\$ 1,525,226</b>

\* Not Graded category include loans that do not have a credit rating as they are considered homogenous loans. Generally mortgage and consumer loans are included in this category.



**Table of Contents**

Certain loans acquired in the Pavilion Bancorp, ComBanc and Genoa acquisitions had evidence that the credit quality of the loan had deteriorated since its origination and in management's assessment at the acquisition date it was probable that the First Defiance would be unable to collect all contractually required payments due. In accordance with FASB ASC Topic 310 Subtopic 30, *Loans and Debt Securities Acquired with Deteriorated Credit Quality*, these loans have been recorded based on management's estimate of the fair value of the loans. Details of these loans are as follows:

	<b>Contractual Amount Receivable</b>	<b>Impairment Discount (In Thousands)</b>	<b>Recorded Loan Receivable</b>
Balance at January 1, 2009	\$ 8,864	\$ 3,068	\$ 5,796
Principal payments received	(2,633)		(2,633)
Loans charged off	(1,110)	(1,110)	
Additional provision for loan loss	(115)		(115)
Loan accretion recorded		(340)	340
Balance at December 31, 2009	5,006	1,618	3,388
Principal payments received	(1,056)		(1,056)
Loans charged off	(300)	(300)	
Additional provision for loan loss	(168)		(168)
Loan accretion recorded		(32)	32
Balance at December 31, 2010	3,482	1,286	2,196
<b>Principal payments received</b>	<b>(413)</b>		<b>(413)</b>
<b>Loans charged off</b>	<b>(250)</b>	<b>(250)</b>	
<b>Additional provision for loan loss</b>	<b>(613)</b>		<b>(613)</b>
<b>Loan accretion recorded</b>		<b>(33)</b>	<b>33</b>
<b>Balance at December 31, 2011</b>	<b>\$ 2,206</b>	<b>\$ 1,003</b>	<b>\$ 1,203</b>

Interest income on loans is as follows:

	<b>Years Ended December 31</b>		
	<b>2011</b>	<b>2010</b>	<b>2009</b>
	<i>(In Thousands)</i>		
Commercial and non-residential real-estate loans	\$ 63,229	\$ 71,547	\$ 73,504
Residential loans	7,545	7,679	9,446
Other loans	7,874	9,402	10,752
Totals	\$ 78,648	\$ 88,628	\$ 93,702

First Defiance's loan portfolio is concentrated geographically in its northwest Ohio market area. Management has also identified lending for income-generating rental properties as an industry concentration. Total loans for income generating property totaled \$373.6 million at December 31, 2011, which represents 25% of the Company's loan portfolio. The Company's loans receivable are primarily to borrowers in the Northwest Ohio, Northeast Indiana or Southeast Michigan areas.

**Table of Contents**

Loans to executive officers, directors, and their affiliates are as follows (in thousands):

	Years Ended December 31	
	2011	2010
Beginning balance	\$ 5,109	\$ 4,812
New loans	5,546	4,599
Effect of changes in composition of related parties		(628)
Repayments	(5,880)	(3,674)
Ending Balance	\$ 4,775	\$ 5,109

**9. Mortgage Banking**

Net revenues from the sales and servicing of mortgage loans consisted of the following:

	Years Ended December 31		
	2011	2010	2009
	(In Thousands)		
Gain from sale of mortgage loans	\$ 5,607	\$ 7,017	\$ 8,744
Mortgage loan servicing revenue (expense):			
Mortgage loan servicing revenue	3,403	3,119	2,860
Amortization of mortgage servicing rights	(2,169)	(2,642)	(3,171)
Mortgage servicing rights valuation adjustments	(404)	353	1,314
	830	830	1,003
Net revenue from sale and servicing of mortgage loans	\$ 6,437	\$ 7,847	\$ 9,747

The unpaid principal balance of residential mortgage loans serviced for third parties was \$1.3 billion at December 31, 2011 and December 31, 2010.

Activity for capitalized mortgage servicing rights and the related valuation allowance follows:

	Years Ended December 31		
	2011	2010	2009
	(In Thousands)		
Mortgage servicing assets:			
Balance at beginning of period	\$ 10,602	\$ 10,436	\$ 9,403
Loans sold, servicing retained	1,786	2,808	4,204
Amortization	(2,169)	(2,642)	(3,171)
Carrying value before valuation allowance at end of period	10,219	10,602	10,436
Valuation allowance:			
Balance at beginning of period	(1,125)	(1,478)	(2,792)
Impairment recovery (charges)	(404)	353	1,314
Balance at end of period	(1,529)	(1,125)	(1,478)
Net carrying value of MSR at end of period	\$ 8,690	\$ 9,477	\$ 8,958

Fair value of MSRs at end of period	\$ 8,690	\$ 9,477	\$ 8,958
-------------------------------------	----------	----------	----------

Amortization of mortgage servicing rights is computed based on payments and payoffs of the related mortgage loans serviced. Estimates of future amortization expense are not easily estimable.

-107-

**Table of Contents**

The Company's servicing portfolio is comprised of the following:

Investor	December 31			
	2011 Number of Loans	Principal Outstanding (Dollars in Thousands)	2010 Number of Loans	Principal Outstanding
Fannie Mae	4,964	\$ 494,115	5,053	\$ 513,076
Freddie Mac	8,328	743,707	8,195	722,000
Federal Home Loan Bank	262	31,139	303	38,529
Other	22	1,426	29	1,575
Totals	13,576	\$ 1,270,387	13,580	\$ 1,275,180

Custodial escrow balances maintained in connection with serviced loans were \$9,057,000 and \$8,509,000 at December 31, 2011 and 2010, respectively.

Significant assumptions at December 31, 2011 used in determining the value of MSRs include a weighted average prepayment rate of 329 PSA and a weighted average discount rate of 9.03%. Significant assumptions at December 31, 2010 used in determining the value of MSRs include a weighted average prepayment rate of 283 PSA and a weighted average discount rate of 9.00%.

A sensitivity analysis of the current fair value to immediate 10% and 20% adverse changes in those assumptions as of December 31, 2011 is presented below. These sensitivities are hypothetical. Changes in fair value based on 10% and 20% variation in assumptions generally cannot be extrapolated because the relationship of the change in the assumption to the change in fair value may not be linear. Also, the effect of a variation in a particular assumption on the fair value of the MSR is calculated independently without changing any other assumption. In reality, changes in one factor may result in changes in another (for example, changes in mortgage interest rates, which drive changes in prepayment rate estimates, could result in changes in the discount rates), which might magnify or counteract the sensitivities.

Assumption:	10% Adverse Change (Dollars in Thousands)	20% Adverse Change (Dollars in Thousands)
Decline in fair value from increase in prepayment rate	\$ 313	\$ 688
Declines in fair value from increase in discount rate	188	438

**Table of Contents****10. Premises and Equipment**

Premises and equipment are summarized as follows:

	December 31 2011	2010 (In Thousands)
Cost:		
Land	\$ 6,836	\$ 6,836
Land improvements	1,269	1,269
Buildings	38,529	38,529
Leasehold improvements	606	582
Furniture, fixtures and equipment	26,075	25,227
Construction in process	946	345
	74,261	72,788
Less allowances for depreciation and amortization	34,216	31,045
	\$ 40,045	\$ 41,743

Depreciation expense was \$3.4 million, \$3.4 million and \$3.8 million for the years ended December 31, 2011, 2010 and 2009, respectively.

**Lease Agreements**

The Company has entered into lease agreements covering First Insurance's main office, Bowling Green, Ohio office, Maumee, Ohio office and Oregon, Ohio office, three banking center locations, two land leases for which the Company owns the banking centers, one land lease which is primarily used for parking, one land lease for future branch development and numerous stand-alone Automated Teller Machine sites with varying terms and options to renew.

Future minimum commitments under non-cancelable operating leases are as follows (in thousands):

2012	\$ 783
2013	454
2014	437
2015	435
2016	426
Thereafter	4,627
Total	\$ 7,162

Rentals under operating leases amounted to \$669,000, \$465,000 and \$504,000, in 2011, 2010, and 2009, respectively.

**Table of Contents****11. Goodwill and Intangible Assets****Goodwill**

The change in the carrying amount of goodwill for the year is as follows:

	2011	December 31 2010 (In Thousands)	2009
Beginning balance	\$ 57,556	\$ 56,585	\$ 56,585
Goodwill acquired or adjusted during the year	3,969	971	
Ending balance	\$ 61,525	\$ 57,556	\$ 56,585

**Acquired Intangible Assets**

Activity in intangibles for the years ended December 31, 2011 and 2010 was as follows:

	Gross Carrying Amount	Accumulated Amortization (In Thousands)	Net Value
Balance as of January 1, 2009	\$ 12,102	\$ (3,758)	\$ 8,344
Amortization of intangible assets		(1,456)	(1,456)
Balance as of December 31, 2009	12,102	(5,214)	6,888
Intangible assets acquired	735		735
Amortization of intangible assets		(1,495)	(1,495)
Balance as of December 31, 2010	12,837	(6,709)	6,128
Intangible assets acquired	1,465		1,465
Amortization of intangible assets		(1,442)	(1,442)
Balance as of December 31, 2011	\$ 14,302	\$ (8,151)	\$ 6,151

Aggregate amortization expense was \$1,442,000, \$1,495,000 and \$1,456,000 for 2011, 2010 and 2009 respectively.

Estimated amortization expense for each of the next five years and thereafter (in thousands) is as follows:

2012	\$ 1,413
2013	1,242
2014	1,102
2015	687
2016	501
Thereafter	1,206
Total	\$ 6,151



**Table of Contents****12. Deposits**

The following schedule sets forth interest expense by type of deposit:

	Years Ended December 31		
	2011	2010	2009
	<i>(In Thousands)</i>		
Checking and money market accounts	\$ 2,144	\$ 3,117	\$ 3,439
Savings accounts	249	362	460
Certificates of deposit	9,782	15,743	22,203
Totals	\$ 12,175	\$ 19,222	\$ 26,102

Accrued interest payable on deposit accounts amounted to \$118,000 and \$251,000 December 31, 2011 and 2010, respectively, which was comprised of \$92,000 and \$26,000 for certificates of deposit and checking and money market accounts, respectively, at December 31, 2011 and \$211,000 and \$40,000 for certificates of deposit and checking and money market accounts, respectively, at December 31, 2010.

A summary of deposit balances is as follows:

	December 31	
	2011	2010
	<i>(In Thousands)</i>	
Non-interest bearing checking accounts	\$ 245,927	\$ 216,699
Interest bearing checking and money market accounts	609,057	555,434
Savings deposits	155,101	144,491
Retail certificates of deposit less than \$100,000	387,607	465,774
Retail certificates of deposit greater than \$100,000	187,913	151,258
Brokered or national certificates of deposit	10,636	41,763
	\$ 1,596,241	\$ 1,575,419

Scheduled maturities of certificates of deposit at December 31, 2011 are as follows (in thousands):

2012	\$ 310,735
2013	175,286
2014	94,088
2015	3,656
2016	1,601
2017 and thereafter	790
Total	\$ 586,156

At December 31, 2011 and 2010, deposits of \$685.0 million and \$604.6 million, respectively, were in excess of \$100,000. Of these same deposits at December 31, 2011 and 2010, deposits of \$328.1 million and \$267.7 million, respectively, were in excess of the \$250,000 FDIC insurance limit. At December 31, 2011 and 2010, \$66.4 million and \$51.3 million, respectively, in investment securities were pledged as collateral against public deposits for certificates in excess of \$100,000 and an additional \$77.7 million and \$72.5 million of securities were pledged at December 31, 2011 and December 31, 2010, respectively, as collateral against deposits from private entities in excess of \$100,000.





**Table of Contents****13. Advances from Federal Home Loan Bank**

First Federal has the ability to borrow funds from the FHLB. First Federal pledges its single-family residential mortgage loan portfolio, certain investment securities, certain first mortgage home equity loans, certain multi-family or non-residential real estate loans, and certain agriculture real estate loans as security for these advances. Advances secured by investment securities must have collateral of at least 105% of the borrowing. Advances secured by residential mortgages must have collateral of at least 125% of the borrowings. Advances secured by multi-family or non-residential real estate loans, and agriculture real estate loans must have 300% collateral coverage. The total level of borrowing is also limited to 50% of total assets and at least 50% of the borrowings must be secured by either one-to-four family residential mortgages or investment securities. Total loans pledged to the FHLB at December 31, 2011 and December 31, 2010 were \$640.2 million and \$632.9 million, respectively. First Federal may obtain advances of up to approximately \$147.9 million from the FHLB at December 31, 2011.

At year-end, advances from the FHLB were as follows:

Principal Terms	Advance Amount (in Thousands)	Range of Maturities	Weighted Average Interest Rate
<b>December 31, 2011</b>			
Short-term borrowings	\$	Overnight	0.00%
Single maturity fixed rate advances	20,000	January 2013 to October 2013	2.79%
Putable advances	44,000	February 2013 to March 2018	4.10%
Strike-rate advances	17,000	October 2012 to February 2013	3.61%
Amortizable mortgage advances	841	December 2015	4.10%
	<b>\$ 81,841</b>		
<b>December 31, 2010</b>			
Short-term borrowings	\$	Overnight	0.00%
Single maturity fixed rate advances	35,000	January 2011 to October 2013	2.39%
Putable advances	54,000	February 2011 to March 2018	4.26%
Strike-rate advances	27,000	March 2011 to February 2013	4.18%
Amortizable mortgage advances	885	December 2015	4.10%
	<b>\$ 116,885</b>		

Putable advances are callable at the option of the FHLB on a quarterly basis. Strike rate advances are callable at the option of the FHLB only when three-month LIBOR rates exceed the agreed upon strike rate in the advance contract. Such strike rates range from 7.5% to 8.0%. When called, First Defiance has the option of paying off these advances or converting them to variable rate advances at the three month LIBOR rate.

Estimated future minimum payments by fiscal year based on maturity date and current interest rates are as follows (in thousands):

2012	\$ 15,023
2013	53,886
2014	553
2015	12,858
2016	119
Thereafter	5,142
Total minimum payments	87,581
Less amounts representing interest	5,740

Totals	\$ 81,841
--------	-----------

-112-

## **Table of Contents**

First Defiance also utilizes short-term advances from the FHLB to meet cash flow needs and for short-term investment purposes. First Defiance borrows short-term advances under a variety of programs at FHLB. At December 31, 2011 and December 31, 2010, there were no amounts outstanding under First Defiance's Cash Management Advance line of credit. The total available under this line is \$15.0 million. In addition, First Defiance has a \$100.0 million REPO Advance line of credit available. There were no borrowings against this line at December 31, 2011 and December 31, 2010. Amounts are generally borrowed under the Cash Management and REPO lines on an overnight basis.

### **14. Junior Subordinated Debentures Owed to Unconsolidated Subsidiary Trust**

In March 2007, the Company sponsored an affiliated trust, First Defiance Statutory Trust II (Trust Affiliate II) that issued \$15 million of Guaranteed Capital Trust Securities (Trust Preferred Securities). In connection with the transaction, the Company issued \$15.5 million of Junior Subordinated Deferrable Interest Debentures (Subordinated Debentures) to Trust Affiliate II. The Company formed Trust Affiliate II for the purpose of issuing Trust Preferred Securities to third-party investors and investing the proceeds from the sale of these capital securities solely in Subordinated Debentures of the Company. The Subordinated Debentures held by Trust Affiliate II are the sole assets of that trust. The Company is not considered the primary beneficiary of this Trust (variable interest entity), therefore the trust is not consolidated in the Company's financial statements, but rather the subordinated debentures are shown as a liability. Distributions on the Trust Preferred Securities issued by Trust Affiliate II are payable quarterly at a fixed rate equal to 6.441% for the first five years and a floating interest rate based on three-month LIBOR plus 1.5%, repricing quarterly, thereafter.

The Trust Preferred Securities issued by Trust Affiliate II are subject to mandatory redemption, in whole or part, upon repayment of the Subordinated Debentures. The Company has entered into an agreement that fully and unconditionally guarantees the Trust Preferred Securities subject to the terms of the guarantee. The Trust Preferred Securities and Subordinated Debentures mature on June 15, 2037, but may be redeemed at the Company's option at any time on or after June 15, 2012, or at any time upon certain events.

The Company also sponsors an affiliated trust, First Defiance Statutory Trust I (Trust Affiliate I), that issued \$20 million of Trust Preferred Securities in 2005. In connection with this transaction, the Company issued \$20.6 million of Subordinated Debentures to Trust Affiliate I. Trust Affiliate I was formed for the purpose of issuing Trust Preferred Securities to third-party investors and investing the proceeds from the sale of these capital securities solely in Subordinated Debentures of the Company. The Junior Debentures held by Trust Affiliate I are the sole assets of the trust. The Company is not considered the primary beneficiary of this Trust (variable interest entity), therefore the trust is not consolidated in the Company's financial statements, but rather the subordinated debentures are shown as a liability. Distributions on the Trust Preferred Securities issued by Trust Affiliate I are payable quarterly at a variable rate equal to the three-month LIBOR rate plus 1.38%. The Coupon rate payable on the Trust Preferred Securities issued by Trust Affiliate I was 1.73% and 1.67% as of December 31, 2011 and 2010 respectively.

The Trust Preferred Securities issued by Trust Affiliate I are subject to mandatory redemption, in whole or in part, upon repayment of the Subordinated Debentures. The Company has entered into an agreement that fully and unconditionally guarantees the Trust Preferred Securities subject to the terms of the guarantee. The Trust Preferred Securities and Junior Debentures mature December 15, 2035 but may be redeemed by the issuer at par after October 28, 2010.

Due to the Company's participation in the U.S. Treasury's CPP, permission must be obtained from the U.S. Treasury in order to call these securities.

**Table of Contents**

A summary of all junior subordinated debentures issued by the Company to affiliates follows. These amounts represent the par value of the obligations owed to these affiliates, including the Company's equity interest in the trusts. Junior subordinated debentures owed to the following affiliates were as follows:

	December 31	
	2011	2010
First Defiance Statutory Trust I due December 2035	\$ 20,619	\$ 20,619
First Defiance Statutory Trust II due June 2037	15,464	15,464
Total junior subordinated debentures owed to unconsolidated subsidiary Trusts	\$ 36,083	\$ 36,083

Interest on both issues of Trust Preferred Securities may be deferred for a period of up to five years at the option of the issuer.

**15. Notes Payable and Other Short-term Borrowings**

Total short-term borrowings, revolving and term debt is summarized as follows:

	Years Ended December 31	
	2011	2010
	<i>(In Thousands, Except Percentages)</i>	
Securities sold under agreement to repurchase		
Amounts outstanding at year-end	\$ 60,386	\$ 56,247
Year-end interest rate	0.92%	0.98%
Average daily balance during year	56,495	47,088
Maximum month-end balance during the year	61,240	56,247
Average interest rate during the year	0.94%	0.97%
Revolving line of credit facilities to financial institutions		
Average daily balance during year	\$	\$
Maximum month-end balance during the year		
Average interest rate during the year	%	%

As of December 31, 2011, First Federal Bank had the following lines of credit facilities available for short-term borrowing purposes:

A \$10 million line of credit with the Federal Reserve Bank Discount Window at an interest rate of 50 basis points over the fed funds rate. The fed funds rate as of December, 31, 2011 was 0.25%.

A \$15 million line of credit with the Bank of America. The rate on this line of credit is Bank of America's fed funds rate, which floats daily.

As of December 31, 2010, First Defiance had no line of credit facilities available for short-term borrowing purposes.

Further, the Company has agreed with its primary regulator not to incur, issue, renew or roll-over any debt, increase any current lines of credit, or guarantee the debt of any entity without the Federal Reserve's prior approval.

**Table of Contents****16. Other Non-Interest Expense**

The following is a summary of other non-interest expense:

	Years Ended December 31		
	2011	2010	2009
	<i>(In Thousands)</i>		
Legal and other professional fees	\$ 2,473	\$ 3,045	\$ 2,486
Marketing	1,392	1,191	1,293
State franchise taxes	2,010	2,088	1,994
REO expenses and write-downs	2,453	4,324	2,245
Printing and office supplies	502	529	569
Amortization of intangibles	1,442	1,495	1,456
Postage	674	668	650
Check charge-offs and fraud losses	493	407	128
Credit and collection expense	874	1,149	1,117
Other	4,318	5,378	4,945
<b>Total other non-interest expense</b>	<b>\$ 16,631</b>	<b>\$ 20,274</b>	<b>\$ 16,883</b>

**17. Postretirement Benefits**

First Defiance sponsors a defined benefit postretirement plan that is intended to supplement Medicare coverage for certain retirees who meet minimum age requirements. First Federal employees who retired prior to April 1, 1997 who completed 20 years of service after age 40 receive full medical coverage at no cost. Such coverage continues for surviving spouses of those participants for one year, after which coverage may be continued provided the spouse pays 50% of the average cost. First Federal employees retiring after April 1, 1997 are provided medical benefits at a cost based on their combined age and years of service at retirement. Surviving spouses are also eligible for continued coverage after the retiree is deceased at a subsidy level that is 10% less than what the retiree is eligible for. First Federal employees retiring before July 1, 1997 receive dental and vision care in addition to medical coverage. First Federal employees who retire after July 1, 1997 are not eligible for dental or vision care, but those retirees and their spouses each receive up to \$200 annually in a medical spending account. Funds in that account may be used for payment of uninsured medical expenses.

First Federal employees who were born after December 31, 1950 are not eligible for the medical coverage described above at retirement. Rather, a medical spending account of up to \$10,000 (based on the participant's age and years of service) will be established to reimburse medical expenses for those individuals. First Insurance employees who were born before December 31, 1950 can continue coverage until they reach age 65, or in lieu of continuing coverage, can elect the medical spending account option, subject to eligibility requirements. Employees hired or acquired after January 1, 2003 are eligible only for the medical spending account option.

## Table of Contents

Included in accumulated other comprehensive income at December 31, 2011 and 2010 are the following amounts that have not yet been recognized in net periodic benefit cost:

	December 31	
	2011	2010
	(In Thousands)	
Unrecognized prior service cost	\$ 46	\$ 56
Unrecognized actuarial losses	1,041	519
Total recognized in Accumulated Other Comprehensive Income	1,087	575
Income tax effect	(380)	(201)
Net amount recognized in Accumulated Other Comprehensive Income	\$ 707	\$ 374

The prior service cost and actuarial loss included in other comprehensive income and expected to be recognized in net postretirement benefit cost during the fiscal year-ended December 31, 2012 is \$40,000 (\$26,000 net of tax) and \$10,000 (\$6,500 net of tax), respectively.

## Reconciliation of Funded Status and Accumulated Benefit Obligation

The plan is not currently funded. The following table summarizes benefit obligation and plan asset activity for the plan measured as of December 31 each year:

	December 31	
	2011	2010
	(In Thousands)	
Change in benefit obligation:		
Benefit obligation at beginning of year	\$ 2,497	\$ 2,734
Service cost	73	73
Interest cost	128	146
Participant contribution	14	14
Actuarial (gains) / losses	537	(349)
Acquisition		
Benefits paid	(132)	(121)
Benefit obligation at end of year	3,117	2,497
Change in fair value of plan assets:		
Balance at beginning of year		
Employer contribution	118	107
Participant contribution	14	14
Benefits paid	(132)	(121)
Balance at end of year		
Funded status at end of year	\$ (3,117)	\$ (2,497)

Net periodic postretirement benefit cost includes the following components:

Years Ended December 31  
2011 2010 2009

Edgar Filing: FIRST DEFIANCE FINANCIAL CORP - Form 10-K

	<i>(In Thousands)</i>		
Service cost-benefits attributable to service during the period	\$ 73	\$ 73	\$ 60
Interest cost on accumulated postretirement benefit obligation	128	146	166
Net amortization and deferral	25	39	56
Net periodic postretirement benefit cost	226	258	282
Net (gain) / loss during the year	537	(349)	(218)
Prior service cost added during the year			
Amortization of prior service cost and actuarial losses	(25)	(39)	(56)
Total recognized in comprehensive income	512	(388)	(274)
Total recognized in net periodic postretirement benefit cost and other comprehensive income	\$ 738	\$ (130)	\$ 8

-116-



## Table of Contents

The following assumptions were used in determining the components of the postretirement benefit obligation:

	2011	2010
Weighted average discount rates:		
Used to determine benefit obligations at December 31	4.25%	5.25%
Used to determine net periodic postretirement benefit cost for years ended December 31	5.25%	5.70%
Assumed health care cost trend rates at December 31:		
Health care cost trend rate assumed for next year	7.50%	8.00%
Rate to which the cost trend rate is assumed to decline (the ultimate trend rate)	4.00%	4.00%
Year that rate reaches ultimate trend rate	2019	2019

The following benefits are expected to be paid over the next five years and in aggregate for the next five years thereafter. Because the plan is unfunded, the expected net benefits to be paid and the estimated Company contributions are the same amount.

	Expected to be Paid (In Thousands)
2012	\$ 133
2013	135
2014	151
2015	151
2016	162
2017 through 2021	967

Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plans. A one-percentage-point change in assumed health care cost trend rates would have the following effect:

	One-Percentage-Point Increase		One-Percentage-Point Decrease	
	Year Ended December 31		Year Ended December 31	
	2011	2010	2011	2010
	(In Thousands)			
Effect on total of service and interest cost	\$ 27	\$ 28	(23)	\$ (24)
Effect on postretirement benefit obligation	431	288	(364)	(247)

The Company expects to contribute \$135,000 before reflecting expected Medicare retiree drug subsidy payments in 2012.

## 18. Regulatory Matters

First Federal is subject to minimum capital adequacy guidelines as set forth in regulations previously adopted by the Office of Thrift Supervision (OTS) which are now enforced by the OCC. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators, which could have a material impact on First Federal's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, First Federal must maintain capital amounts in excess of specified minimum ratios based on quantitative measures of First Federal's assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices.

**Table of Contents**

Quantitative measures previously established by the OTS to ensure capital adequacy require First Federal to maintain minimum amounts and ratios (as set forth in the table below) of total and Tier 1 capital (as defined in the regulations) to risk-weighted assets, and Tier 1 capital to adjusted total assets.

The following schedule presents First Federal Bank's regulatory capital ratios as of December 31, 2011 and December 31, 2010:

	December 31, 2011					
	Actual Amount	Ratio	Minimum Required for Adequately Capitalized Amount	Ratio	Minimum Required for Well Capitalized Amount	Ratio
<b><u>Tier 1 Capital (1)</u></b>						
First Federal Bank	\$ 231,787	11.62%	\$ 79,757	4.0%	\$ 99,697	5.0%
<b><u>Tier 1 Capital (to Risk Weighted Assets) (1)</u></b>						
First Federal Bank	\$ 231,787	14.16%	\$ 65,492	4.0%	\$ 98,238	6.0%
<b><u>Total Capital (to Risk Weighted Assets) (1)</u></b>						
First Federal Bank	\$ 252,411	15.42%	\$ 130,984	8.0%	\$ 163,730	10.0%

- (1) Core capital is computed as a percentage of adjusted total assets of \$1.99 billion for the Bank. Risk-based capital is computed as a percentage of total risk-weighted assets of \$1.64 billion for the Bank.

	December 31, 2010					
	Actual Amount	Ratio	Minimum Required for Adequately Capitalized Amount	Ratio	Minimum Required for Well Capitalized Amount	Ratio
<b><u>Tier 1 Capital (1)</u></b>						
First Federal Bank	\$ 213,625	10.81%	\$ 79,055	4.0%	\$ 98,819	5.0%
<b><u>Tier 1 Capital (to Risk Weighted Assets) (1)</u></b>						
First Federal Bank	\$ 213,625	12.84%	\$ 66,571	4.0%	\$ 99,856	6.0%
<b><u>Total Capital (to Risk Weighted Assets) (1)</u></b>						
First Federal Bank	\$ 234,576	14.09%	\$ 133,141	8.0%	\$ 166,426	10.0%

- (1) Core capital is computed as a percentage of adjusted total assets of \$1.98 billion for the bank. Risk-based capital is computed as a percentage of total risk-weighted assets of \$1.66 billion for the Bank.

Management believes that, as of December 31, 2011, First Federal Bank was well capitalized based on the ratios presented above.

First Federal Bank is subject to the regulatory capital requirements administered by the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation. Regulatory authorities can initiate certain mandatory actions if First Federal Bank fails to meet the minimum capital requirements, which could have a direct material effect on the Corporation's financial statements. Management believes, as of December 31, 2011, that First Federal Bank meets all capital adequacy requirements to which they are subject.

## Table of Contents

First Defiance is a unitary thrift holding company and is regulated by the Federal Reserve. At the present time, capital requirements for Savings and Loan Holding Company s have not been completed yet and therefore, First Defiance is not yet subject to regulatory capital requirements under the Federal Reserve.

**Dividend Restrictions** Dividends paid by First Federal to First Defiance are subject to various regulatory restrictions. First Federal did not pay dividends in 2011 and paid \$4.8 million in dividends in 2010. First Federal can initiate dividend payments equal to its net profits (as defined by statute) for 2010 and 2011 plus 2012 net profits. During 2012, First Federal could declare dividends of approximately \$20.6 million plus 2012 net profits to First Defiance. First Federal must receive approval from the OCC prior to the payment of any such dividend, and it may apply to the OCC to pay total dividends that exceed an amount equal to its 2010 to 2012 net profits. First Insurance did not pay dividends to First Defiance in 2011 and paid \$1.0 million in dividends in 2010.

As a result of its participation in the CPP, First Defiance is prohibited without prior approval of the U.S. Treasury, from paying a quarterly cash dividend of more than \$0.26 per share until the U.S. Treasury s preferred stock is redeemed or transferred to an unaffiliated third party. Further, First Defiance has agreed to obtain OCC approval prior to the declaration of dividends. First Defiance declared and paid a \$0.05 per share common stock dividend in December of 2011.

## 19. Income Taxes

The components of income tax expense are as follows:

	Years Ended December 31		
	2011	2010	2009
	(In Thousands)		
Current:			
Federal	\$ 3,714	\$ 5,372	\$ 6,590
State and local	(91)	50	84
Deferred	3,042	(2,417)	(4,007)
	\$ 6,665	\$ 3,005	\$ 2,667

The provision for income taxes differs from that computed at the statutory corporate tax rate as follows:

	Years Ended December 31		
	2011	2010	2009
	(In Thousands)		
Tax expense at statutory rate (35%)	\$ 7,769	\$ 3,889	\$ 3,451
Increases (decreases) in taxes from:			
State income tax net of federal tax benefit	(59)	32	55
ESOP adjustments			
Tax exempt interest income, net of TEFRA	(926)	(745)	(673)
Bank owned life insurance	(230)	(278)	(311)
Stock option expense	36	54	76
Other	75	53	69
Totals	\$ 6,665	\$ 3,005	\$ 2,667

Deferred federal income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes.

**Table of Contents**

Significant components of First Defiance's deferred federal income tax assets and liabilities are as follows:

	December 31 2011	2010 (In Thousands)
Deferred federal income tax assets:		
Allowance for loan losses	\$ 11,639	\$ 14,296
Postretirement benefit costs	1,090	874
Deferred compensation	910	900
Impaired loans	809	1,310
Capital loss carry-forward	621	621
Impaired investments	872	804
Accrued vacation	521	476
Allowance for real estate held for sale losses	195	748
Deferred loan origination fees and costs	238	309
Other	460	347
 Total deferred federal income tax assets	 17,355	 20,685
Deferred federal income tax liabilities:		
FHLB stock dividends	3,284	3,284
Goodwill	3,781	3,172
Mortgage servicing rights	3,043	3,291
Fixed assets	1,449	1,524
Other intangible assets	1,393	1,871
Loan mark to market	1,062	1,405
Net unrealized gains on available-for-sale securities	2,533	17
Other	384	316
 Total deferred federal income tax liabilities	 16,929	 14,880
 Net deferred federal income tax asset (liability)	 \$ 426	 \$ 5,805

The realization of the Company's deferred tax assets is dependent upon the Company's ability to generate taxable income in future periods and the reversal of deferred tax liabilities during the same period. The Company has evaluated the available evidence supporting the realization of its deferred tax assets and determined it is more likely than not that the assets will be realized and thus no valuation allowance was required at December 31, 2011.

At December 31, 2011, the Company had capital loss carry-forwards of \$1.8 million which will expire on December 31, 2014. No valuation allowance has been recorded as management has evaluated evidence supporting the realization of this asset and determined it is more likely than not that the asset will be realized.

Retained earnings at December 31, 2011 include approximately \$11.0 million for which no tax provision for federal income taxes has been made. This amount represents the tax bad debt reserve at December 31, 1987, which is the end of the Company's base year for purposes of calculating the bad debt deduction for tax purposes. If this portion of retained earnings is used in the future for any purpose other than to absorb bad debts, the amount used will be added to future taxable income. The unrecorded deferred tax liability on the above amount at December 31, 2011 was approximately \$3.85 million.

**Table of Contents**

A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows (in thousands):

Balance at January 1, 2009	\$ 444
Additions based on tax positions related to the current year	
Additions for tax positions of prior years	
Reductions for tax positions of prior years	
Reductions due to the statute of limitations	(98)
Settlements	
Balance at December 31, 2009	\$ 346
Balance at January 1, 2010	\$ 346
Additions based on tax positions related to the current year	
Additions for tax positions of prior years	
Reductions for tax positions of prior years	
Reductions due to the statute of limitations	(65)
Settlements	
Balance at December 31, 2010	\$ 281
Balance at January 1, 2011	\$ 281
Additions based on tax positions related to the current year	
Additions for tax positions of prior years	
Reductions for tax positions of prior years	
Reductions due to the statute of limitations	(140)
Settlements	
Balance at December 31, 2011	\$ 141

The Company does not expect the total amount of unrecognized tax benefits to significantly increase or decrease in the next twelve months.

The total amount of interest and penalties recorded in the income statement, net of the related federal tax benefit, for the year ended December 31, 2011 was \$14,000, and the amount accrued for interest and penalties (net of the related federal tax benefit) at December 31, 2011 was \$73,000.

The Company and its subsidiaries are subject to U.S. federal income tax as well as income tax in the state of Indiana. The Company is no longer subject to examination by taxing authorities for years before 2007. The Company currently operates primarily in the states of Ohio and Michigan, which tax financial institutions based on their equity rather than their income.

**20. Employee Benefit Plans****401(k) Plan**

Employees of First Defiance are eligible to participate in the First Defiance Financial Corp. 401(k) Employee Savings Plan (First Defiance 401(k)) if they meet certain age and service requirements. Beginning in 2009, under the First Defiance 401(k), First Defiance matches 100% of the participants' contributions up to 3% of compensation and then 50% of the participants' contributions for the next 2% of compensation. Previously, matching contributions were 50% of the first 3% of participants' contributions. The First Defiance 401(k) also provides for a discretionary First Defiance contribution in addition to the First Defiance matching contribution. First Defiance matching contributions totaled \$717,000, \$660,000 and \$719,000 for the years ended December 31, 2011, 2010 and 2009, respectively. There were no discretionary contributions in any of those years.



## **Table of Contents**

### **Group Life Plan**

On June 30, 2010, First Federal adopted the First Federal Bank of the Midwest Executive Group Life Plan Post Separation (the Group Life Plan) in which various employees, including the Company's named executive officers, may participate. Under the terms of the Group Life Plan, First Federal will purchase and own life insurance policies covering the lives of employees selected by the board of directors of First Federal as participants. There was \$137,000 and \$547,000 of expense recorded for the years ended December 31, 2011 and 2010, respectively, with a liability of \$683,000 and \$547,000 for future benefits recorded at December 31, 2011 and 2010, respectively.

### **21. Stock Option Plans**

First Defiance has established incentive stock option plans for its directors and employees. On March 15, 2010, the Board adopted, and the shareholders approved at the 2010 Annual Shareholders Meeting, the First Defiance Financial Corp. 2010 Equity Incentive Plan (the 2010 Equity Plan). The 2010 Equity Plan replaces all existing plans. All awards currently outstanding under the prior plans will remain in effect in accordance with their respective terms. Any new awards will be made under the 2010 Equity Plan. The 2010 Equity Plan allows for issuance of up to 350,000 option or restricted share awards.

As of December 31, 2011, 317,800 options have been granted and remain outstanding at option prices based on the market value of the underlying shares on the date the options were granted. Options granted under all plans vest 20% per year except for the 2009 grant to the Company's executive officers, which vest 40% in 2011 and then 20% annually, subject to certain other limitations required by the Emergency Economic Stabilization Act of 2008. All options expire ten years from date of grant. Vested options of retirees expire on the earlier of the scheduled expiration date or three months after the retirement date.

On August 15, 2011, the Company approved a Short-Term and a Long-Term Equity Incentive Plan for selected members of management. The Plans are effective January 1, 2011 and provide for cash and/or equity benefits if certain performance targets are achieved. Awards issued under these Plans will reduce the amount of awards available to be issued under the 2010 Equity Plan.

The Short-Term Equity Incentive Plan includes nine members of management. These participants may earn up to 25% to 45% of their 2011 salary for potential payout under the Short-Term Equity Incentive Plan. The final amount of benefit was determined at December 31, 2011 based on the achievement of certain targets which each contribute from 10% to 25% of the total potential benefit earned. The targets include diluted earnings per share, net charge offs to average loans, non-performing assets to total assets, classified assets to total assets, return on average equity and return on average assets. Two of the Participants in the Plan are high-compensated employees (HCEs) who are not eligible to receive cash payments and therefore their total potential benefit will be paid out as restricted share awards. These participants earned a total of 13,554 awards as a result of targets being achieved. The expense associated with payment of these awards was considered an equity arrangement for accounting purposes and was accounted for as a component of equity. For the year ended December 31, 2011 total expense of \$162,000 has been recorded through equity associated with the estimated benefits to these participants. The remaining participants have the option to receive their potential benefits in cash, restricted share awards, or a combination thereof. Accordingly any expense associated with payment of these benefits is considered a liability award for accounting purposes and will be accounted for as an accrued liability. For the year ended December 31, 2011 total expense of \$220,000 was recorded and is included within other liabilities. The benefits earned under this plan will be paid out as follows 50% in the first quarter of 2012, 25% in the first quarter of 2013, and 25% in the first quarter of 2014. The participants are required to be employed on the day of payout in order to receive such payment.

**Table of Contents**

The Long-Term Equity Incentive Plan includes nine members of management. These participants may earn up to 25% to 45% of their 2011 salary for potential payout under the Long-Term Equity Incentive Plan. The final amount of benefit will be determined at December 31, 2012 based on the achievement of certain targets which each contribute from 33% to 34% of the total potential benefit earned. The targets include a peer comparison of return on average equity, earnings per share growth and revenue growth. Two of the Participants in the Plan are high-compensated employees ( HCE s ) who are not eligible to receive cash payments and therefore their total potential benefit will be paid out as restricted share awards. These participants may earn up to a maximum of 13,554 awards if all targets are achieved. Any estimated expense associated with payment of these awards is considered an equity arrangement for accounting purposes and will be accounted for as a component of equity. For the year ended December 31, 2011 total expense of \$49,000 has been recorded through equity associated with the estimated benefits to these participants. The remaining participants have the option to receive their potential benefits in cash, restricted share awards, or a combination thereof. Accordingly any expense associated with payment of these benefits is considered a liability award for accounting purposes and will be accounted for as an accrued liability. For the year ended December 31, 2011 total expense of \$60,000 was recorded and is included within other liabilities. The benefits earned under this plan will be paid out in full in the first quarter of 2013. The participants are required to be employed on the day of payout in order to receive such payment.

The fair value of each option award is estimated on the date of grant using the Black-Scholes model using the assumptions noted in the table below. Expected volatilities are based on historical volatilities of the Company s common stock. The Company uses historical data to estimate option exercise and post-vesting termination behavior. The expected term of options granted is based on historical data and represents the period of time that options granted are expected to be outstanding, which takes into account that the options are not transferable. The risk-free interest rate for the expected term of the option is based on the U.S. Treasury yield curve in effect at the time of the grant.

The fair value of options granted was determined using the following weighted-average assumptions as of grant date.

	Year Ended December 31		
	2011	2010	2009
Risk-free interest rate		1.57%	3.38%
Expected term		7.2 years	6.4 years
Expected stock price volatility		44.6%	26.1%
Dividend yield		0.00%	3.62%



**Table of Contents**

The following table summarizes stock option activity for 2011:

	<b>Options Outstanding</b>	<b>Weighted Average Exercise Price</b>	<b>Weighted Average Remaining Contractual Term (in years)</b>	<b>Aggregate Intrinsic Value (in \$000s)</b>
Outstanding at January 1, 2011	415,000	\$ 19.17		
Granted				
Exercised	850	12.59		
Forfeited/Expired	96,350	15.34		
Outstanding at December 31, 2011	317,800	\$ 20.35	4.94	\$ 317
Vested or expected to vest at December 31, 2011	317,800	\$ 20.35	4.94	\$ 317
Exercisable at December 31, 2011	238,840	\$ 22.30	4.33	\$ 118

Information related to the stock option plans follows:

	<b>Year Ended December 31,</b>		
	<b>2011</b>	<b>2010</b>	<b>2009</b>
	<i>(in thousands, except per share amounts)</i>		
Intrinsic value of options exercised	\$ 1	\$ 1	\$ 1
Cash received from option exercises	11	3	5
Tax benefit realized from option exercises			
Weighted average fair value of options granted		\$ 4.05	\$ 1.88

As of December 31, 2011, there was \$122,000 of total unrecognized compensation cost related to non-vested stock options granted under the Company Stock Option Plans. The cost is expected to be recognized over a weighted-average period of 1.9 years.

In March 2011, First Defiance granted restricted stock awards ( RSA ) under the 2010 Equity Plan, which provides for the issuance of shares to directors, officers and employees. Compensation expense is recognized over the vesting period of the awards based on the fair value of the stock at issue date. The fair value of the stock was determined using the closing price of First Defiance common stock on the date of the grant. The restricted stock shares fully vest on the second anniversary of the grant date.

<b>Unvested Shares</b>	<b>Shares</b>	<b>Weighted-Average Grant Date Fair Value Per Share</b>
Unvested at January 1, 2011		\$
Granted	18,292	12.56
Vested		
Forfeited		
Unvested at December 31, 2011	18,292	12.56

As of December 31, 2011, there was \$39,000 of total unrecognized compensation cost related to unvested shares granted under the Plan. The cost is expected to be recognized over a weighted-average period of 1.18 years.



**Table of Contents**

As of December 31, 2011 and 2010, 326,708 and 345,000 shares, respectively, were available for grant under the Company's stock option plans. Options forfeited or cancelled under all plans except the 2010 plan are no longer available for grant to other participants

**22. Parent Company Statements**

Condensed parent company financial statements, which include transactions with subsidiaries, follow:

<i>Statements of Financial Condition</i>	<b>December 31</b>	
	<b>2011</b>	<b>2010</b>
	<i>(In Thousands)</i>	
<b>Assets</b>		
Cash and cash equivalents	\$ 11,466	\$ 1,868
Available for Sale Securities	2,010	0
Investment in banking subsidiary	287,823	266,752
Investment in non-bank subsidiary	12,205	6,976
Other assets	1,783	1,744
<b>Total assets</b>	<b>\$ 315,287</b>	<b>\$ 277,340</b>
<b>Liabilities and stockholders' equity:</b>		
Subordinated debentures	\$ 36,083	\$ 36,083
Accrued liabilities	1,077	926
Stockholders' equity	278,127	240,331
<b>Total liabilities and stockholders' equity</b>	<b>\$ 315,287</b>	<b>\$ 277,340</b>

  

<i>Statements of Income</i>	<b>Years Ended December 31</b>		
	<b>2011</b>	<b>2010</b>	<b>2009</b>
	<i>(In Thousands)</i>		
Dividends from subsidiaries	\$ 8	\$ 5,802	\$ 6,050
Interest on investments	8		
Interest expense	(1,278)	(1,315)	(1,471)
Other-than-temporary impairment on investment securities			(419)
Other income	1		(3)
Noninterest expense	(690)	(857)	(881)
<b>Income (loss) before income taxes and equity in earnings of subsidiaries</b>	<b>(1,959)</b>	<b>3,630</b>	<b>3,276</b>
Income tax credit	(665)	(739)	(950)
<b>Income (loss) before equity in earnings of subsidiaries</b>	<b>(1,294)</b>	<b>4,369</b>	<b>4,226</b>
Undistributed equity in (distributions in excess of)			
earnings of subsidiaries	16,828	3,739	2,968
<b>Net income</b>	<b>\$ 15,534</b>	<b>\$ 8,108</b>	<b>\$ 7,194</b>
<b>Comprehensive income</b>	<b>\$ 19,873</b>	<b>\$ 7,924</b>	<b>\$ 8,940</b>

**Table of Contents**

<i>Statements of Cash Flows</i>	Years Ended December 31		
	2011	2010	2009
	<i>(In Thousands)</i>		
Operating activities:			
Net income	\$ 15,534	\$ 8,108	\$ 7,194
Adjustments to reconcile net income to net cash (used in) provided by operating activities:			
Distribution in excess of (undistributed equity in) earnings of subsidiaries	(16,828)	(3,739)	(2,968)
OTTI on investment securities			419
Change in other assets and liabilities	109	(1,045)	741
Net cash provided by (used in) operating activities	(1,185)	3,324	5,386
Investing activities:			
Investment in non-bank subsidiary	(4,785)	(1,500)	
Purchase of available-for-sale securities	(2,000)		
Net cash (used in) provided by investing activities	(6,785)	(1,500)	
Financing activities:			
Equity incentive plans	40	3	5
Cash dividends paid	(2,331)	(1,850)	(5,523)
Proceeds from issuance of common stock	19,859		
Net cash used in financing activities	17,567	(1,847)	(5,518)
Net increase (decrease) in cash and cash equivalents	9,598	(23)	(132)
Cash and cash equivalents at beginning of year	1,868	1,891	2,023
Cash and cash equivalents at end of year	\$ 11,466	\$ 1,868	\$ 1,891

**23. Fair Value**

FASB ASC Topic 820 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. A fair value measurement assumes that the transaction to sell the asset or transfer the liability occurs in the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability. The price in the principal (or most advantageous) market used to measure the fair value of the asset or liability shall not be adjusted for transaction costs. An orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets and liabilities; it is not a forced transaction. Market participants are buyers and sellers in the principal market that are (i) independent, (ii) knowledgeable, (iii) able to transact and (iv) willing to transact.

FASB ASC Topic 820 requires the use of valuation techniques that are consistent with the market approach, the income approach and/or the cost approach. The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets and liabilities. The income approach uses valuation techniques to convert future amounts, such as cash flows or earnings, to a single present amount on a discounted basis. The cost approach is based on the amount that currently would be required to replace the service capacity of an asset (replacement cost). Valuation techniques should be consistently applied. Inputs to valuation techniques refer to the assumptions that market participants would use in pricing the asset or liability. Inputs may be observable, meaning those that reflect the assumptions market participants would use in pricing the asset or liability developed based on the best information available. In that regard, FASB ASC Topic 820 established a fair value hierarchy for valuation inputs that gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. The fair value hierarchy is as follows:

*Level 1:* Quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date.



## **Table of Contents**

*Level 2:* Inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. These might include quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, inputs other than quoted prices that are observable for the asset or liability (such as interest rates, prepayment speeds, credit risks, etc.) or inputs that are derived principally from or corroborated by market data by a correlation or other means.

*Level 3:* Unobservable inputs for determining fair value of assets and liabilities that reflect an entity's own assumptions about the assumptions that market participants would use in pricing the assets or liabilities.

A description of the valuation methodologies used for instruments measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy, is set forth below.

**Available for sale securities** - Securities classified as available for sale are generally reported at fair value utilizing Level 2 inputs where the Company obtains fair value measurements from an independent pricing service which uses matrix pricing, which is a mathematical technique widely used in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities (Level 2 inputs). The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows and the bonds' terms and conditions, among other things. Securities in Level 1 include preferred stock securities. Securities in Level 2 include U.S. Government agencies, mortgage-backed securities, corporate bonds and municipal securities. The Company classifies its pooled trust preferred collateralized debt obligations as Level 3. The portfolio consists of collateralized debt obligations backed by pools of trust preferred securities issued by financial institutions and insurance companies. Based on the lack of observable market data, the Company estimated fair values based on the observable data available and reasonable unobservable market data. The Company estimated fair value based on a discounted cash flow model which used appropriately adjusted discount rates reflecting credit and liquidity risks. The Company used an independent third party which is described further in Note 6.

**Impaired loans** - The fair value of impaired loans with specific allocations of the allowance for loan loss is generally based on recent real estate appraisals. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are typically significant and result in impaired loans being valued using Level 3 inputs.

**Mortgage servicing rights** - Mortgage servicing rights are reported at fair value utilizing Level 2 inputs. MSRs are valued by a third party consultant using a proprietary cash flow valuation model.

## Table of Contents

**Mortgage banking derivative** - The fair value of mortgage banking derivatives are based on derivative valuation models using market data inputs as of the valuation date (Level 2).

**Real estate held for sale** - Real estate held for sale is determined using Level 3 inputs which include current and prior appraisals and estimated costs to sell.

The following table summarizes the financial assets measured at fair value on a recurring basis segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure fair value:

### Assets and Liabilities Measured on a Recurring Basis

December 31, 2011	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
			(In Thousands)	
Available for sale securities:				
Obligations of U.S. Government corporations and agencies	\$	\$ 17,085	\$	\$ 17,085
US Treasury bonds		2,010		2,010
Mortgage-backed securities - residential		70,716		70,716
REMICs		2,894		2,894
Collateralized mortgage obligations		59,009		59,009
Trust preferred stock			1,342	1,342
Preferred stock	108			108
Corporate bonds		8,252		8,252
Obligations of state and political subdivisions		71,503		71,503
Mortgage banking derivative - asset		865		865
Mortgage banking derivative - liability		(258)		(258)

# Table of Contents

December 31, 2010	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
			(In Thousands)	
Available for sale securities:				
Obligations of U.S. Government corporations and agencies	\$	\$ 11,985	\$	\$ 11,985
Mortgage-backed securities - residential REMICs		40,576		40,576
Collateralized mortgage obligations		3,541		3,541
Trust preferred stock		51,057		51,057
Preferred stock	48		1,498	1,498
Corporate bonds		3,797		3,797
Obligations of state and political subdivisions		52,750		52,750
Mortgage banking derivative - asset		265		265
The table below presents a reconciliation and income classification of gains and losses for all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the years ended December 31, 2011 and December 31, 2010:				

	Fair Value Measurements Using Significant Unobservable Inputs (Level 3) (In Thousands)
Beginning balance, January 1, 2011	\$ 1,498
Total gains or losses (realized/unrealized)	
Included in earnings	(2)
Included in other comprehensive income (presented gross of taxes)	(159)
Amortization	5
Sales	
Transfers in and/or out of Level 3	
Ending balance, December 31, 2011	\$ 1,342

	Fair Value Measurements Using Significant Unobservable Inputs (Level 3) (In Thousands)
Beginning balance, January 1, 2010	\$ 1,589
Total gains or losses (realized/unrealized)	
Included in earnings	(214)
Included in other comprehensive income (presented gross of taxes)	128
Purchases, issuances, and settlements	20
Sales	(25)
Transfers in and/or out of Level 3	
Ending balance, December 31, 2010	\$ 1,498



**Table of Contents**

The following table summarizes assets measured at fair value on a non-recurring basis segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure fair value:

**Assets and Liabilities Measured on a Non-Recurring Basis**

December 31, 2011	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs (In Thousands)	Total Fair Value
Impaired Loans				
Residential Loans	\$	\$	\$ 1,092	\$ 1,092
Commercial Loans			1,268	1,268
Multi Family Loans			103	103
CRE loans			8,449	8,449
Total Impaired loans			10,912	10,912
Mortgage servicing rights		8,690		8,690
Residential Loans			28	28
CRE loans			1,600	1,600
Real estate held for sale			1,628	1,628

December 31, 2010	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs (In Thousands)	Total Fair Value
Impaired Loans				
Residential Loans	\$	\$	\$ 2,541	\$ 2,541
Commercial Loans			7,236	7,236
Multi Family Loans			962	962
CRE loans			16,835	16,835
Total Impaired loans			27,574	27,574
Mortgage servicing rights		9,477		9,477
Residential Loans			1,474	1,474
CRE loans			1,975	1,975

Real estate held for sale 3,449 3,449

Impaired loans, which are measured for impairment using the fair value of the collateral for collateral dependent loans, had a fair value of \$10.9 million, with a valuation allowance of \$7.2 million at December 31, 2011. A provision expense of \$5.4 million for year ended December 31, 2011 was included in earnings.

Mortgage servicing rights which are carried at lower of cost or fair value had a fair value of \$8,690,000 at December 31, 2011, resulting in a valuation allowance of \$1,529,000. A charge of \$404,000 was included in the earnings for the year ended December 31, 2011.

Real estate held for sale is determined using Level 3 inputs which include current and prior appraisals and estimated costs to sell. The change in fair value of real estate held for sale was \$1,047,000 for the year ended December 31, 2011 was recorded directly as an adjustment to current earnings through non-interest expense.

Impaired loans, which are measured for impairment using the fair value of the collateral for collateral dependent loans, had a fair value of \$27.6 million, with a valuation allowance of \$16.6 million at December 31, 2010. A provision expense of \$18.0 million for year ended December 31, 2010 was included in earnings.



## **Table of Contents**

Mortgage servicing rights which are carried at lower of cost or fair value had a fair value of \$9,477,000 at December 31, 2010, resulting in a valuation allowance of \$1,125,000. A recovery of \$353,000 was included in the earnings for the year ended December 31, 2010.

Real estate held for sale is determined using Level 3 inputs which include current and prior appraisals and estimated costs to sell. The change in fair value of real estate held for sale was \$3,196,000 for the year ended December 31, 2010 was recorded directly as an adjustment to current earnings through non-interest expense.

In accordance with FASB ASC Topic 825, the following table is a comparative condensed consolidated statement of financial condition based on carrying amount and estimated fair values of financial instruments as of December 31, 2011 and December 31, 2010. Accordingly, the aggregate fair value amounts presented do not represent the underlying value of First Defiance.

Much of the information used to arrive at fair value is highly subjective and judgmental in nature and therefore the results may not be precise. Subjective factors include, among other things, estimated cash flows, risk characteristics and interest rates, all of which are subject to change. With the exception of investment securities, the Company's financial instruments are not readily marketable and market prices do not exist. Since negotiated prices for the instruments, which are not readily marketable depend greatly on the motivation of the buyer and seller, the amounts that will actually be realized or paid per settlement or maturity of these instruments could be significantly different.

The carrying amount of cash and cash equivalents, warehouse and term notes payable, and advance payments by borrowers for taxes and insurance, and accrued interest receivable and payable as a result of their short-term nature, is considered to be equal to fair value.

As disclosed in more detail in Note 6, investment securities fair value has been based on current market quotations. If market prices are not available, fair value has been estimated based upon the quoted price of similar instruments or based on observable and unobservable data. It was not practicable to determine the fair value of FHLB stock due to restrictions placed on its transferability.

The fair value of loans which reprice within 90 days is equal to their carrying amount. For other loans, the estimated fair value is calculated based on discounted cash flow analysis, using interest rates currently being offered for loans with similar terms. The allowance for loan losses is considered to be a reasonable adjustment for credit risk.

FASB ASC Topic 825 requires that the fair value of demand, savings, NOW and certain money market accounts be equal to their carrying amount. The Company believes that the fair value of these deposits may be greater or less than that prescribed by FASB ASC Topic 825.

**Table of Contents**

The carrying value of Subordinated Debentures and deposits with fixed maturities is estimated based on interest rates currently being offered on instruments with similar characteristics and maturities. FHLB advances with maturities greater than 90 days are valued based on discounted cash flow analysis, using interest rates currently being quoted for similar characteristics and maturities. The cost or value of any call or put options is based on the estimated cost to settle the option at December 31, 2011.

	December 31, 2011		December 31, 2010	
	Carrying Value	Estimated Fair Values	Carrying Value	Estimated Fair Values
	(In Thousands)			
<b>Assets:</b>				
Cash and cash equivalents	\$ 174,931	\$ 174,931	\$ 169,164	\$ 169,164
Investment securities	233,580	233,591	166,091	166,117
Federal Home Loan Bank Stock	20,655	N/A	21,012	N/A
Loans, net, including loans				
held for sale	1,467,663	1,494,573	1,496,550	1,498,990
Mortgage banking derivative asset	865	865	265	265
Accrued interest receivable	6,142	6,142	6,374	6,374
	1,903,836	\$ 1,910,102	1,859,456	\$ 1,840,910
Other assets	164,354		176,061	
Total assets	\$ 2,068,190		\$ 2,035,517	
<b>Liabilities and stockholders' equity:</b>				
Deposits	\$ 1,596,241	\$ 1,603,111	\$ 1,575,419	\$ 1,582,539
Advances from Federal Home Loan Bank	81,841	85,196	116,885	121,504
Securities sold under repurchase agreements	60,386	60,386	56,247	55,443
Subordinated debentures	36,083	31,814	36,083	32,258
Accrued interest payable	446	446	724	724
Mortgage banking derivative liability	258	258		
Advance payments by borrowers for taxes and insurance	1,402	1,402	937	937
	1,776,399	\$ 1,782,613	1,786,295	\$ 1,793,405
Other liabilities	13,664		8,891	
Total liabilities	1,790,063		1,795,186	
Stockholders' equity	278,127		240,331	
Total liabilities and stockholders' equity	\$ 2,068,190		\$ 2,035,517	

**Table of Contents****24. Derivative Financial Instruments**

Commitments to fund certain mortgage loans (interest rate locks) to be sold into the secondary market and forward commitments for the future delivery of mortgage loans to third party investors are considered derivatives. It is the Company's practice to enter into forward commitments for the future delivery of residential mortgage loans when interest rate lock commitments are entered into in order to economically hedge the effect of changes in interest rates resulting from its commitments to fund the loans. These mortgage banking derivatives are not designated in hedge relationships. First Federal had approximately \$21.7 million and \$24.9 million of interest rate lock commitments at December 31, 2011 and 2010, respectively. There were \$34.4 million and \$34.7 million of forward commitments for the future delivery of residential mortgage loans at December 31, 2011 and 2010, respectively.

The fair value of these mortgage banking derivatives are reflected by a derivative asset or a derivative liability. The table below provides data about the carrying values of these derivative instruments:

	Assets Carrying Value	December 31, 2011 (Liabilities) Carrying Value	Derivative Net Carrying Value (In Thousands)	Assets Carrying Value	December 31, 2010 (Liabilities) Carrying Value	Derivative Net Carrying Value
<b>Derivatives not designated as hedging instruments</b>						
Mortgage Banking Derivatives	\$ 865	\$ (258)	\$ 607	\$ 265	\$	\$ 265

The table below provides data about the amount of gains and losses recognized in income on derivative instruments not designated as hedging instruments:

	Twelve Months Ended December 31,		
	2011	2010	2009
<b>Derivatives not designated as hedging instruments</b>			
Mortgage Banking Derivatives Gain (Loss)	\$ 252	\$ (115)	\$ (718)

The above amounts are included in mortgage banking income with gain on sale of mortgage loans. During the first quarter of 2011, management determined that a group of loans, previously classified as held for sale, were no longer sellable and were transferred back into the portfolio. As a result, a \$90,000 loss related to a fair value adjustment on those loans was recorded in the first quarter of 2011.

**Table of Contents****25. Quarterly Consolidated Results of Operations (Unaudited)**

The following is a summary of the quarterly consolidated results of operations:

	March 31	Three Months Ended		December 31
		June 30	September 30	
	<i>(In Thousands, Except Per Share Amounts)</i>			
<b>2011</b>				
Interest income	\$ 22,158	\$ 21,973	\$ 21,666	\$ 21,270
Interest expense	4,956	4,457	4,019	3,754
Net interest income	17,202	17,516	17,647	17,516
Provision for loan losses	2,833	2,405	3,097	4,099
Net interest income after provision for loan losses	14,369	15,111	14,550	13,417
Gain (loss) on sale, call or write-down of securities	47			169
Noninterest income	5,898	6,838	6,857	7,707
Noninterest expense	16,626	15,086	15,462	15,589
Income before income taxes	3,688	6,863	5,945	5,704
Income taxes	1,028	2,113	1,884	1,640
Net income	\$ 2,660	\$ 4,750	\$ 4,061	\$ 4,064
Dividends declared on Preferred Shares	(462)	(463)	(463)	(462)
Accretion on Preferred Shares	(43)	(44)	(45)	(46)
Net income applicable to common shares	\$ 2,155	\$ 4,243	\$ 3,553	\$ 3,556
Earnings per common share:				
Basic	\$ 0.25	\$ 0.44	\$ 0.37	\$ 0.37
Diluted	\$ 0.25	\$ 0.43	\$ 0.36	\$ 0.36
Average shares outstanding:				
Basic	8,519	9,724	9,725	9,726
Diluted	8,671	9,902	9,895	9,908

**Table of Contents**

	March 31	Three Months Ended		December 31
		June 30	September 30	
	(In Thousands, Except Per Share Amounts)			
<b>2010</b>				
Interest income	\$ 24,129	\$ 24,349	\$ 24,057	\$ 23,329
Interest expense	7,044	6,788	6,295	5,574
Net interest income	17,085	17,561	17,762	17,755
Provision for loan losses	6,889	5,440	5,196	5,652
Net interest income after provision for loan losses	10,196	12,121	12,566	12,103
Gain (loss) on sale, call or write-down of securities	(64)	(71)	(190)	(14)
Noninterest income	6,830	5,862	7,669	7,568
Noninterest expense	14,832	15,045	17,102	16,485
Income before income taxes	2,130	2,867	2,943	3,172
Income taxes	624	808	668	904
Net income	\$ 1,506	\$ 2,059	\$ 2,275	\$ 2,268
Dividends declared on Preferred Shares	(463)	(462)	(463)	(463)
Accretion on Preferred Shares	(40)	(42)	(43)	(43)
Net income applicable to common shares	\$ 1,003	\$ 1,555	\$ 1,769	\$ 1,762
Earnings per common share:				
Basic	\$ 0.12	\$ 0.19	\$ 0.22	\$ 0.22
Diluted	\$ 0.12	\$ 0.19	\$ 0.22	\$ 0.22
Average shares outstanding:				
Basic	8,117	8,118	8,118	8,118
Diluted	8,142	8,193	8,118	8,178

**26. Preferred Stock**

On December 5, 2008, as part of the Capital Purchase Program ( CPP ), the Company entered into a Letter Agreement and Securities Purchase Agreement (collectively, the Purchase Agreement ) with the U.S. Treasury, pursuant to which the Company sold \$37.0 million shares of newly authorized Fixed Rate Cumulative Perpetual Preferred Stock, par value \$0.01 per share and liquidation value \$1,000 per share ( Senior Preferred Shares ) and also issued warrants (the Warrants ) to the U.S. Treasury to acquire an additional 550,595 of common shares having an exercise price of \$10.08 per share. The Warrants have a term of 10 years.

The Senior Preferred Shares qualify as Tier 1 capital and will pay cumulative dividends at a rate of 5% per annum for the first five years, and 9% per annum thereafter. The Senior Preferred Shares may be redeemed by the Company after three years. The Senior Preferred Shares are not subject to any contractual restrictions on transfer, except that the U.S. Treasury or any its transferees may affect any transfer that, as a result of such transfer, would require the Company to become subject to the periodic reporting requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934.

Pursuant to the terms of the Purchase Agreement, the ability of the Company to declare or pay dividends or distributions on, or purchase, redeem or otherwise acquire for consideration, its common shares will be subject to restrictions, including a restriction against increasing dividends from the last quarterly cash dividend per share of \$0.26 declared on the common stock prior to October 14, 2008. The redemption, purchase or other acquisition of trust preferred securities of the Company or its affiliates also will be restricted. These restrictions will terminate on the earlier of (a) the third anniversary of the date of issuance of the Senior Preferred Shares and (b) the date on which the Senior Preferred Shares have been redeemed in whole or the U.S. Treasury has transferred all of the Senior Preferred Shares to third parties, except that, after the third anniversary of the date of issuance of the Senior Preferred Shares, if the Senior Preferred Shares remain outstanding at such time, the Company may not

increase its common dividends per share without obtaining consent of the U.S. Treasury.

-135-



---

**Table of Contents**

The Purchase Agreement also subjects the Company to certain of the executive compensation limitations included in the Emergency Economic Stabilization Act of 2008 (the "EESA"). As a condition to the closing of the transaction, the Company's Senior Executive Officers (as defined in the Purchase Agreement) (the "Senior Executive Officers"), (i) voluntarily waived any claim against the U.S. Treasury or the Company for any changes to such officer's compensation or benefits that are required to comply with the regulation issued by the U.S. Treasury under the CPP and acknowledged that the regulation may require modification of the compensation, bonus, incentive and other benefit plans, arrangements and policies and agreements as they relate to the period the U.S. Treasury owns the Senior Preferred Shares of the Company; and (ii) entered into a letter agreement with the Company amending the Benefit Plans with respect to such Senior Executive Officers as may be necessary, during the period that the U.S. Treasury owns the Senior Preferred Shares, as necessary to comply with Section 111(b) of the EESA.

The Company intends to redeem the Senior Preferred Shares and the Warrants as soon as it is prudent to do so. However, there are three factors the Company will continue to consider when evaluating redemption: (a) evidence of a sustained economic recovery, (b) the Company's sustained profitable performance with growth in earnings, and (c) additional clarity of any new regulatory capital thresholds. The Company anticipates that it will redeem the Senior Preferred Shares and the Warrants within five years from the date of issuance, December 5, 2013, utilizing existing funds at that time. The companies' earnings and capital levels have steadily improved over the past several quarters and the Company has seen improvement in the economic environment it operates. While the Company still believes that more clarity of any new capital level requirements is necessary, the Company feels that its overall financial position has improved to a level that would indicate a higher likelihood that the company would request approval for the repayment of TARP in the near term.

**27. Common Stock Offering**

In March 2011, the Company completed its previously announced underwritten public common stock offering by issuing 1,600,800 shares of the Company's common stock, including 208,800 shares issued pursuant to the exercise of the underwriter's over-allotment option, at a price of \$13.25 per share for gross proceeds of \$21.2 million. The net proceeds to the Company after deducting underwriting discounts and commissions and offering expenses were \$19.9 million.

## **Table of Contents**

### **Item 9. Changes In and Disagreements With Accountants on Accounting and Financial Disclosure**

None.

### **Item 9a. Controls and Procedures**

First Defiance's management carried out an evaluation, under the supervision and with the participation of the chief executive officer and the chief financial officer, of the effectiveness of First Defiance's disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) as of December 31, 2011. Based upon that evaluation, the chief executive officer along with the interim chief financial officer concluded that First Defiance's disclosure controls and procedures as of December 31, 2011, are effective.

The information set forth under Management's Report on Internal Control Over Financial Reporting and Report of Independent Registered Public Accounting Firm included in Item 8 above is incorporated herein by reference.

### **Changes in Internal Control Over Financial Reporting**

There were no changes in First Defiance's internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the last fiscal quarter ended December 31, 2011 that have materially affected, or are reasonably likely to materially affect First Defiance's internal control over financial reporting.

### **Item 9b. Other Information**

None

## **PART III**

### **Item 10. Directors, Executive Officers and Corporate Governance**

The information required herein is incorporated by reference from the sections captioned: Proposal 1 - Election of Directors, Executive Officers, and Section 16(a) Beneficial Ownership Reporting Compliance of the definitive proxy statement to be filed on or about March 25, 2011 (the Proxy Statement).

First Defiance has adopted a Code of Ethics applicable to all officers, directors and employees that complies with SEC requirements, and is available on its Internet site at [www.fdef.com](http://www.fdef.com) under the Investor Relations tab.

### **Item 11. Executive Compensation**

Information required by this item is set forth under the captions Executive Compensation, Director Compensation, Compensation Committee Report and Compensation Committee Interlocks and Insider Participation of the Proxy Statement.

## Table of Contents

### Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

The information set forth under the caption Beneficial Ownership of the Proxy Statement is incorporated herein by reference.

### Equity Compensation Plans

The following table provides information as of December 31, 2011 with respect to the shares of First Defiance common stock that may be issued under First Defiance's existing equity compensation plans.

Plan Category	Number of securities to be Issued Upon Exercise of Outstanding Options, Warrants and Rights (a)	Weighted Average Exercise Price of Outstanding Options, Warrants and Rights (b)	Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (Excluding Securities Reflected in Column (a)) (c)
Equity Compensation Plans Approved by Security Holders	317,800	\$ 20.35	340,262

### Item 13. Certain Relationships and Related Transactions, and Director Independence

The information set forth under the captions Composition of the Board and Related Person Transactions of the Proxy Statement is incorporated herein by reference.

### Item 14. Principal Accountant Fees and Services

The information set forth under the caption Independent Registered Public Accounting Firm of the Proxy Statement is incorporated herein by reference.

**Table of Contents**

**PART IV**

**Item 15. Exhibits, Financial Statement Schedules**

(a) Financial Statements

The following documents are filed as Item 8 of this Form 10-K.

- (A) Report of Independent Registered Public Accounting Firm (Crowe Horwath LLP)
- (B) Consolidated Statements of Financial Condition as of December 31, 2011 and 2010
- (C) Consolidated Statements of Income for the years ended December 31, 2011, 2010 and 2009
- (D) Consolidated Statements of Stockholders' Equity for the years ended December 31, 2011, 2010 and 2009
- (E) Consolidated Statements of Cash Flows for the years ended December 31, 2011, 2010 and 2009
- (F) Notes to Consolidated Financial Statements

- (1) We are not filing separate financial statement schedules because of the absence of conditions under which they are required or because the required information is included in the consolidated financial statements or the related notes.

**Table of Contents**

**SIGNATURES**

Pursuant to the requirements of Sections 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

FIRST DEFIANCE FINANCIAL CORP.

March 7, 2012

By: /s/ Donald P. Hileman  
Donald P. Hileman, Chief Financial Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities indicated on March 7, 2012.

<b>Signature</b>	<b>Title</b>
/s/ William J. Small William J. Small	Chairman of the Board, President and Chief Executive Officer
/s/ Donald P. Hileman Donald P. Hileman	Executive Vice President and Chief Financial Officer (principal accounting officer)
/s/ James L. Rohrs James L. Rohrs	Director, Executive Vice President
/s/ Stephen L. Boomer Stephen L. Boomer	Director, Vice Chairman
/s/ John L. Bookmyer John L. Bookmyer	Director
/s/ Dr. Douglas A. Burgei Dr. Douglas A. Burgei	Director
/s/ Peter A. Diehl Peter A. Diehl	Director
/s/ Barb A. Mitzel Barb A. Mitzel	Director
/s/ Dwain I. Metzger Dwain I. Metzger	Director
/s/ Jean A. Hubbard Jean A. Hubbard	Director
/s/ Samuel S. Strausbaugh Samuel S. Strausbaugh	Director
/s/ Thomas A. Voigt Thomas A. Voigt	Director

## Table of Contents

### Exhibit Index

This report incorporates by reference the documents listed below that we have previously filed with the SEC. The SEC allows us to incorporate by reference information in this document. The information incorporated by reference is considered to be part of this document.

This information may be read and copied at the Public Reference Room of the SEC at 100 F Street, N.E., Washington D.C. 20549. The SEC also maintains an internet web site that contains reports, proxy statements, and other information about issuers, like First Defiance, who file electronically with the SEC. The address of the site is <http://www.sec.gov>. The reports and other information filed by First Defiance with the SEC are also available at the First Defiance Financial Corp. web site. The address of the site is <http://www.fdef.com>. Except as specifically incorporated by reference into this Annual Report on Form 10-K, information on those web sites is not part of this report.

Exhibit Number	Description	
3.1	Articles of Incorporation	(1)
3.2	Code of Regulations	(1)
3.3	Bylaws	(1)
3.4	Amendment to Articles of Incorporation	(11)
4.1	Agreement to furnish instruments and agreements defining rights of holders of long-term debt	(17)
4.2	Form of Warrant for Purchase of Shares of Common Stock	(15)
10.1	1996 Stock Option Plan	(2)
10.2	Form of Incentive Stock Option Award Agreement under 2001 Plan	(3)
10.3	Form of Nonqualified Stock Option Award Agreement under 1996 Plan	(3)
10.4	1996 Management Recognition Plan and Trust	(8)
10.5	2001 Stock Option and Incentive Plan	(5)
10.7	Employment Agreement with William J. Small	(6)
10.8	Employment Agreement with James L. Rohrs	(7)
10.9	Employment Agreement with Donald P. Hileman	(18)
10.10	Employment Agreement with Gregory R. Allen	(9)
10.12	2005 Stock Option and Incentive Plan	(10)
10.13	Letter Agreement, dated December 5, 2008, between First Defiance and the U.S. Treasury	(12)
10.14	2008 Long Term Incentive Compensation Plan (LTIP)	(13)
10.15	Form of Contingent Award Agreement under LTIP	(14)
10.16	Form of Stock Option Award Agreement under 2005 Plan	(4)
10.17	Amendment to all Employment Agreements for CPP	(4)
10.18	Form of Agreement for CPP Compensation Standards	(21)
10.19	Form of Option Award Agreement with EESA restriction under 2005 Plan	(21)
10.20	First Federal Executive Group Life Plan Post Separation	(19)
10.21	2010 Equity Incentive Plan	(20)
10.22	Form of Restricted Stock Award Agreement	(22)
10.23	2010 Equity Plan Form of Long-Term Incentive Plan Award Agreement	(23)

## Edgar Filing: FIRST DEFIANCE FINANCIAL CORP - Form 10-K

10.24	2010 Equity Plan Form of Short-Term Incentive Plan Award Agreement	(24)
10.25	2010 Equity Plan Form of Long-Term Incentive Plan Award Agreement (with TARP Restrictions)	(25)
10.26	2010 Equity Plan Form of Short-Term Incentive Plan Award Agreement (with TARP Restrictions)	(26)
21	List of Subsidiaries of the Company	(17)
23.1	Consent of Crowe Horwath LLP	(17)
31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	(17)
31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	(17)

-141-

## **Table of Contents**

32.1	Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	(17)
32.2	Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	(17)
99.1	PEO TARP Capital Purchase Program Certification	(17)
99.2	PFO TARP Capital Purchase Program Certification	(17)
101	Interactive data files pursuant to Rule 405 of Regulation S-T: (i) the Consolidated Condensed Balance Sheet, (ii) the Consolidated Condensed Statements of Income, (iii) the Consolidated Condensed Statements of Changes in Equity, (iv) the Consolidated Condensed Statements of Cash Flows, and (v) the Notes to Consolidated Condensed Financial Statements tagged as blocks of text and in detail.	(27)

- (1) Incorporated herein by reference to the like numbered exhibit in the Registrant's Form S-1 (File No. 33-93354)
- (2) Incorporated herein by reference to like numbered exhibit in Registrant's 2001 Form 10-K (Film No. 02580719)
- (3) Incorporated herein by reference to like numbered exhibit in Registrant's 2004 Form 10-K (Film No. 0568550)
- (4) Incorporated herein by reference to like numbered exhibit in Registrant's 2008 Form 10-K (Film No. 09683948)
- (5) Incorporated herein by reference to Appendix B to the 2001 Proxy Statement (Film No. 1577137)
- (6) Incorporated herein by reference to exhibit 10.1 in Form 8-K filed October 1, 2007 (Film No. 071144951)
- (7) Incorporated herein by reference to exhibit 10.2 in Form 8-K filed October 1, 2007 (Film No. 071144951)
- (8) Incorporated herein by reference to exhibit 10.2 in Registrant's 2001 Form 10-K (Film No. 02580719)
- (9) Incorporated herein by reference to exhibit 10.4 in Form 8-K filed October 1, 2007 (Film No. 071144951)
- (10) Incorporated herein by reference to Appendix A to the 2005 Proxy Statement (Film No. 05692264)
- (11) Incorporated herein by reference to exhibit 3 in Form 8-K filed December 8, 2008 (Film No. 081236105)
- (12) Incorporated herein by reference to exhibit 10 in Form 8-K filed December 8, 2008 (Film No. 081236105)
- (13) Incorporated herein by reference to exhibit 10.1 in Form 8-K filed December 12, 2008 (Film No. 081245224)



## Edgar Filing: FIRST DEFIANCE FINANCIAL CORP - Form 10-K

- (14) Incorporated herein by reference to exhibit 10.2 in Form 8-K filed December 12, 2008 (Film No. 081245224)
- (15) Incorporated herein by reference to exhibit 4 in Form 8-K filed December 8, 2008 (Film No. 081236105)
- (17) Included herein
- (18) Incorporated herein by reference to exhibit 10.1 in Form 8-K filed December 16, 2009 (Film No. 091245196)
- (19) Incorporated herein by reference to exhibit 10.1 in Form 10-Q filed November 2, 2010 (Film No. 101158262)
- (20) Incorporated herein by reference to Annex A to 2010 Proxy Statement (Film No. 10693151)
- (21) Incorporated herein by reference to like numbered exhibit in Registrant's 2010 Form 10-K (Film No. 10652528)
- (22) Incorporated herein by reference to exhibit 10.1 in Form 10-Q filed May 5, 2011 (Film No. 11803357)
- (23) Incorporated herein by reference to exhibit 10.1 in Form 10-Q filed November 8, 2011 (Film No. 111188059)
- (24) Incorporated herein by reference to exhibit 10.2 in Form 10-Q filed November 8, 2011 (Film No. 111188059)

-142-

**Table of Contents**

(25) Incorporated herein by reference to exhibit 10.3 in Form 10-Q filed November 8, 2011 (Film No. 111188059)

(26) Incorporated herein by reference to exhibit 10.4 in Form 10-Q filed November 8, 2011 (Film No. 111188059)

(27) As provided in Rule 406T of Regulation S-T, this information is furnished and not filed for purposes of Sections 11 and 12 of the Securities Act 1933 and Section 18 of the Securities Exchange Act of 1934.

-143-