FIRST DEFIANCE FINANCIAL CORP
Form 10-Q
November 09, 2012

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

x Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the Quarterly Period Ended September 30, 2012

OR

.. Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the Transition Period from ___________to__________

Commission file number 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

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 x No ¨

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

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

Large accelerated filer ¨	Accelerated filer x
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 x

APPLICABLE ONLY TO CORPORATE ISSUERS

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practical date. Common Stock, $.01 Par Value – 9,729,267 shares outstanding at November 2, 2012.

FIRST DEFIANCE FINANCIAL CORP.

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PART I-FINANCIAL INFORMATION

Item 1. Financial Statements

FIRST DEFIANCE FINANCIAL CORP.

Consolidated Condensed Statements of Financial Condition

(Amounts in Thousands, except share and per share data)

	September 30, 2012 (Unaudited)	December 31, 2011
Assets		
Cash and cash equivalents:		
Cash and amounts due from depository institutions	$ 32,406	$ 31,931
Federal funds sold	60,000	143,000
	92,406	174,931
Securities:		
Available-for-sale, carried at fair value	269,098	232,919
Held-to-maturity, carried at amortized cost (fair value $595 and $672 at September 30, 2012 and December 31, 2011, respectively)	585	661
	269,683	233,580
Loans held for sale	12,201	13,841
Loans receivable, net of allowance of $26,310 at September 30, 2012 and $33,254 at December 31, 2011, respectively	1,485,822	1,453,822
Accrued interest receivable	6,819	6,142
Federal Home Loan Bank stock	20,655	20,655
Bank owned life insurance	41,591	35,908
Premises and equipment	40,324	40,045
Real estate and other assets held for sale	2,843	3,628
Goodwill	61,525	61,525
Core deposit and other intangibles	5,083	6,151
Mortgage servicing rights	7,752	8,690
Deferred taxes	-	629
Other assets	8,968	8,643
Total assets	$ 2,055,672	$ 2,068,190

(continued)

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FIRST DEFIANCE FINANCIAL CORP.

Consolidated Condensed Statements of Financial Condition

(Amounts in Thousands, except share and per share data)

	September 30, 2012 (Unaudited)	December 31, 2011
Liabilities and stockholders' equity		
Liabilities:		
Deposits	$ 1,609,350	$ 1,596,241
Advances from the Federal Home Loan Bank	81,807	81,841
Subordinated debentures	36,083	36,083
Securities sold under repurchase agreements	51,991	60,386
Advance payments by borrowers	971	1,402
Deferred taxes	1,479	-
Other liabilities	18,855	14,110
Total liabilities	1,800,536	1,790,063
Stockholders' equity:		
Preferred stock, $.01 par value per share: 37,000 shares authorized; 0 and 37,000 issued with a liquidation preference of $0 and $37,231, respectively, net of discount	-	36,641
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 9,729,267 and 9,726,243 shares outstanding, respectively	127	127
Common stock warrant	878	878
Additional paid-in capital	136,138	135,825
Accumulated other comprehensive income, net of tax of $3,156 and $2,153, respectively	5,863	3,997
Retained earnings	159,433	148,010
Treasury stock, at cost, 3,010,229 and 3,013,253 shares respectively	(47,303)	(47,351)
Total stockholders' equity	255,136	278,127
Total liabilities and stockholders' equity	$ 2,055,672	$ 2,068,190

See accompanying notes

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FIRST DEFIANCE FINANCIAL CORP.

Consolidated Condensed Statements of Income

(UNAUDITED)

(Amounts in Thousands, except share and per share data)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Interest Income				
Loans	$ 18,000	$ 19,488	$ 54,847	$ 59,553
Investment securities:				
Taxable	1,093	1,207	3,473	3,398
Non-taxable	749	658	2,146	1,833
Interest-bearing deposits	43	110	249	351
FHLB stock dividends	213	203	656	662
Total interest income	20,098	21,666	61,371	65,797
Interest Expense				
Deposits	1,909	2,791	6,394	9,648
FHLB advances and other	759	768	2,260	2,442
Subordinated debentures	172	333	813	945
Notes payable	83	127	284	397
Total interest expense	2,923	4,019	9,751	13,432
Net interest income	17,175	17,647	51,620	52,365
Provision for loan losses	705	3,097	8,306	8,335
Net interest income after provision for loan losses	16,470	14,550	43,314	44,030
Non-interest Income				
Service fees and other charges	2,790	3,071	8,148	8,435
Insurance and investment commission income	1,952	2,042	6,679	5,146
Mortgage banking income	2,220	1,355	6,924	4,549
Gain on sale of non-mortgage loans	8	52	50	351
Gain on sale or call of securities	103	-	528	49
Other-than-temporary impairment (OTTI) losses on investment securities				
Total impairment losses on investment securities	-	-	-	(23)
Losses recognized in other comprehensive income	-	-	-	21
Net impairment loss recognized in earnings	-	-	-	(2)
Trust income	147	143	470	465
Income from Bank Owned Life Insurance	244	228	683	703
Other non-interest income	316	(34)	712	(56)
Total non-interest income	7,780	6,857	24,194	19,640
Non-interest Expense				
Compensation and benefits	8,245	8,173	24,760	23,458
Occupancy	2,170	1,779	5,718	5,423

FDIC insurance premium	691	674	2,031	2,264
State franchise tax	623	541	1,649	1,625
Data processing	1,140	1,077	3,477	3,117
Acquisition related charges	-	99	-	234
Amortization of intangibles	344	386	1,068	1,051
Other non-interest expense	3,237	2,733	9,538	10,003
Total non-interest expense	16,450	15,462	48,241	47,175
Income before income taxes	7,800	5,945	19,267	16,495
Federal income taxes	2,366	1,884	5,759	5,024
Net Income	$ 5,434	$ 4,061	$ 13,508	$ 11,471
Dividends accrued on preferred shares	$ (3)	$ (463)	$ (900)	$ (1,388)
Accretion on preferred shares	$ (8)	$ (45)	$ (359)	$ (132)
Redemption of preferred shares	$ -	$ -	$ 642	$ -
Net income applicable to common shares	$ 5,423	$ 3,553	$ 12,891	$ 9,951
Earnings per common share (Note 6)				
Basic	$ 0.56	$ 0.37	$ 1.33	$ 1.08
Diluted	$ 0.54	$ 0.36	$ 1.29	$ 1.06
Dividends declared per share (Note 5)	$ 0.05	$ -	$ 0.15	$ -
Average common shares outstanding (Note 6)				
Basic	9,729	9,725	9,728	9,248
Diluted	10,000	9,895	9,993	9,417

See accompanying notes

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FIRST DEFIANCE FINANCIAL CORP.

Consolidated Condensed Statements of Comprehensive Income

(UNAUDITED)

(Amounts in Thousands)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Net Income	$ 5,434	$ 4,061	$ 13,508	$ 11,471
Other comprehensive income:				
Unrealized gains/losses on securities				
Unrealized holding gains on securities arising during the period	1,953	3,303	3,397	7,003
Reclassification adjustment for (gains) losses realized in income	(103)	-	(528)	(49)
Other-than-temporary impairment losses on securities realized in income	-	-	-	2
Net unrealized gains	1,850	3,303	2,869	6,956
Income tax effect	(647)	(1,155)	(1,003)	(2,435)
Other comprehensive income	1,203	2,148	1,866	4,521
Comprehensive income	$ 6,637	$ 6,209	$ 15,374	$ 15,992

FIRST DEFIANCE FINANCIAL CORP.

Consolidated Condensed Statements of Changes in Stockholders' Equity

(UNAUDITED)

(Amounts in Thousands)

	Preferred Stock	Common Stock	Common Stock Warrant	Additional Paid-In Capital	Accumulated Other Comprehensive Income (Loss)	Retained Earnings	Treasury Stock	Total Stockholders' Equity
Balance at January 1, 2012	$36,641	$ 127	$ 878	$135,825	$ 3,997	$148,010	$(47,351)	$278,127
Net income	-	-	-	-	-	13,508	-	13,508
Change in net unrealized gains and losses on available-for-sale securities					1,866			1,866
Stock option expense	-	-	-	82	-	-	-	82
500 shares issued under stock option plan with no income tax benefit	-	-	-	-	-	(4)	8	4
Restricted share activity under Stock Incentive Plans	-	-	-	230	-	-	30	260
637 shares issued direct purchases	-	-	-	1	-	-	10	11
Preferred Stock Dividends accrued	-	-	-	-	-	(900)	-	(900)
Accretion on preferred shares	359	-	-	-	-	(359)	-	-
16,560 shares purchased in U.S. Treasury auction	(16,560)	-	-	-	-	618	-	(15,942)
20,440 shares purchased in open market	(20,440)	-	-	-	-	24	-	(20,416)
Common stock dividends declared	-	-	-	-	-	(1,464)	-	(1,464)
Balance at September 30, 2012	$-	$ 127	$ 878	$136,138	$ 5,863	$159,433	$(47,303)	$255,136

Balance at January 1, 2011	$36,463	$ 127	$ 878	$140,845	$ (342)	$134,988	$(72,628)	$ 240,331
Net income	-	-	-	-	-	11,471	-	11,471
Change in net unrealized gains and losses on available-for-sale securities	-	-	-	-	4,521	-	-	4,521
Stock option expense	-	-	-	109	-	-	-	109
850 shares issued under stock option plan, with no income tax benefit	-	-	-	-	-	(3)	14	11
1,600,800 shares issued capital stock	-	-	-	(5,297)	-	-	25,156	19,859
Restricted share activity under Stock Incentive Plans	-	-	-	108	-	-	75	183
1,476 shares issued direct purchases	-	-	-	(2)	-	-	23	21
Preferred Stock Dividends accrued	-	-	-	-	-	(1,388)	-	(1,388)
Accretion on preferred shares	131	-	-	-	-	(131)	-	-
Balance at September 30, 2011	$36,594	$ 127	$ 878	$135,763	$ 4,179	$144,937	$(47,360)	$ 275,118

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FIRST DEFIANCE FINANCIAL CORP.

Consolidated Condensed Statements of Cash Flows

(UNAUDITED)

(Amounts in Thousands)

	Nine Months Ended September 30, 2012	2011
Operating Activities		
Net income	$13,508	$11,471
Items not requiring (providing) cash		
Provision for loan losses	8,306	8,335
Depreciation	2,552	2,581
Amortization of mortgage servicing rights, net of valuation adjustments	3,465	1,934
Amortization of core deposit and other intangible assets	1,068	1,051
Net amortization of premiums and discounts on loans and deposits	516	742
Amortization of premiums and discounts on securities	621	(311)
Loss on sale or disposals of property, plant and equipment	43	66
Change in deferred taxes	1,104	383
Proceeds from the sale of loans held for sale	381,875	168,163
Originations of loans held for sale	(374,872)	(167,746)
Gain from sale of loans	(7,940)	(4,305)
OTTI losses on investment securities	-	2
Gain from sale or call of securities	(528)	(49)
Loss on sale or write-down of real estate and other assets held for sale	302	779
Stock option expense	82	109
Restricted stock expense	260	-
Income from bank owned life insurance	(683)	(703)
Changes in:		
Accrued interest receivable	(677)	(280)
Other assets	(325)	907
Other liabilities	4,873	5,044
Net cash provided by (used in) operating activities	33,550	28,173
Investing Activities		
Proceeds from maturities of held-to-maturity securities	76	103
Proceeds from maturities, calls and pay-downs of available-for-sale securities	49,571	28,453
Proceeds from sale of real estate and other assets held for sale	2,901	7,380
Proceeds from the sale of available-for-sale securities	8,538	1,982
Proceeds from sale of non-mortgage loans	371	5,520

Purchases of available-for-sale securities	(91,513)	(87,825)
Proceeds from sale of office properties and equipment	-	12
Proceeds from Federal Home Loan Bank stock redemption	-	357
Purchase of bank-owned life insurance	(5,000)	-
Purchases of portfolio mortgage loans	-	(10,696)
Net cash paid for Payak-Dubbs Insurance Agency, Inc.	-	(3,914)
Purchases of premises and equipment, net	(2,874)	(1,571)
Net (increase) decrease in loans receivable	(43,572)	55,671
Net cash provided by investing activities	(81,502)	(4,528)
Financing Activities		
Net increase in deposits and advance payments by borrowers	12,689	14,542
Repayment of Federal Home Loan Bank advances	(34)	(35,033)
Decrease in securities sold under repurchase agreements	(8,395)	(770)
Net cash received from common stock issuance	-	19,859
Cash paid for redemption of preferred stock	(36,358)	-
Proceeds from exercise of stock options	4	11
Proceeds from treasury stock purchases	11	21
Proceeds from restricted stock units	-	183
Cash dividends paid on common stock	(1,464)	-
Cash dividends paid on preferred stock	(1,026)	(1,388)
Net cash provided by (used in) financing activities	(34,573)	(2,575)
Increase (decrease) in cash and cash equivalents	(82,525)	21,070
Cash and cash equivalents at beginning of period	174,931	169,164
Cash and cash equivalents at end of period	$92,406	$190,234
Supplemental cash flow information:		
Interest paid	$9,814	$13,644
Income taxes paid	$800	$3,200
Transfers from loans to real estate and other assets held for sale	$2,418	$4,373
Transfers from loans held for sale to loans	$-	$7,596
Securities traded but not yet settled	$-	$2,673

See accompanying notes.

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FIRST DEFIANCE FINANCIAL CORP.

Notes to Consolidated Condensed Financial Statements

(Unaudited at September 30, 2012 and 2011)

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. ("First Insurance"). All significant intercompany transactions and balances are eliminated in consolidation.

First Federal is primarily engaged in attracting deposits from the general public 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.

The consolidated condensed statement of financial condition at December 31, 2011 has been derived from the audited financial statements at that date, which were included in First Defiance's Annual Report on Form 10-K.

The accompanying consolidated condensed financial statements as of September 30, 2012 and for the three and nine month periods ended September 30, 2012 and 2011 have been prepared by First Defiance without audit and do not include information or footnotes necessary for the complete presentation of financial condition, results of operations, and cash flows in conformity with accounting principles generally accepted in the United States. These consolidated condensed financial statements should be read in conjunction with the financial statements and notes thereto included in First Defiance's 2011 Annual Report on Form 10-K for the year ended December 31, 2011. However, in the opinion of management, all adjustments, consisting of only normal recurring items, necessary for the fair presentation of the financial statements have been made. The results for the three and nine month periods ended September 30, 2012 are not necessarily indicative of the results that may be expected for the entire year.

2. Significant 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, accretion of preferred stock discount and redemption of preferred stock) 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 or units and stock grants.

New Accounting Pronouncements

In July 2012, the Financial Accounting Standards Board (“FASB”) issued ASU No. 2012-02, *“Testing Indefinite-Lived Intangible Assets for Impairment.”* The provisions of ASU No. 2012-02 permit an entity to first assess qualitative factors to determine whether it is more likely than not that an indefinite-lived intangible asset is impaired as a basis for determining whether it is necessary to perform a quantitative impairment test, as is currently required by GAAP. ASU No. 2012-02 is effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012. The adoption of ASU No. 2012-02 is expected to have no impact on the Company’s financial position, results of operations or cash flows.

3. 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.

- *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 that 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 federal agency 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 7.

Impaired loans - Fair values for impaired collateral dependent loans are generally based on appraisals obtained from licensed real estate appraisers and in certain circumstances consideration of offers obtained to purchase properties prior to foreclosure. Appraisals for collateral dependent impaired loans are ordered annually. These appraisals are ordered and reviewed by the Company's loan officers or loan workout personnel. Appraisals for commercial real estate generally use three methods to derive value: cost, sales or market comparison and income approach. The cost method bases value in the cost to replace the current property. Value of market comparison approach evaluates the sales price of similar properties in the same market area. The income approach considers net operating income generated by the property and an investors required return. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available. Comparable sales adjustments are based on known sales prices of similar type and similar use properties and duration of time that the property has been on the market to sell. Such adjustments made in the appraisal process are typically significant and result in a Level 3 classification of the inputs for determining fair value. Appraisal values for impaired loans of all loan classes are discounted between a range of 0% to 10% to account for various factors that may impact the value of collateral.

Real Estate held for sale - Assets acquired through or instead of loan foreclosure are initially recorded at fair value less costs to sell when acquired, establishing a new cost basis. These assets are then reviewed monthly by members of the asset review committee for valuation changes and are accounted for at lower of cost or fair value less estimated costs to sell. Fair value is commonly based on recent real estate appraisals which may utilize a single valuation approach or a combination of approaches including cost, comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available. Such adjustments may be significant and typically result in a Level 3 classification of the inputs for determining fair value.

Appraisals for both collateral-dependent impaired loans and other real estate owned are performed by certified general appraisers (for commercial properties) or certified residential appraisers (for residential properties) whose qualifications and licenses have been reviewed and verified by the Company. Once received, a member of the Company's loan workout personnel or collections department reviews the assumptions and approaches utilized in the appraisal. Appraisal values for all classes of real estate held for sale are discounted between a range of 0% to 20% to account for various factors that may impact the value of collateral. In determining the value of impaired collateral dependent loans and other real estate owned, significant unobservable inputs may be used which include: physical condition of comparable properties sold, net operating income generated by the property and investor rates of return.

Mortgage servicing rights – On a quarterly basis, mortgage servicing rights are evaluated for impairment based upon the fair value of the rights as compared to the carrying amount. If the carrying amount of an individual tranche exceeds fair value, impairment is recorded on that tranche so that the servicing asset is carried at fair value. Fair value is determined at a tranche level based on a model that calculates the present value of estimated future net servicing income. The valuation model utilizes assumptions that market participants would use in estimating future net servicing income and are validated against available market data (Level 2).

Mortgage banking derivative - The fair value of mortgage banking derivatives are evaluated monthly based on derivative valuation models using quoted prices for similar assets adjusted for specific attributes of the commitments and other observable market data at the valuation date (Level 2).

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:

<u>Assets and Liabilities Measured on a Recurring Basis</u>

September 30, 2012	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	$ -	$ 21,649	$ -	$ 21,649
U.S. treasury bonds		2,004		2,004
Mortgage-backed - residential	-	85,495	-	85,495
REMICs	-	-	-	-
Collateralized mortgage obligations	-	65,030	-	65,030
Trust preferred stock	-	-	1,308	1,308
Preferred stock	69	-	-	69
Corporate bonds	-	8,849	-	8,849

Obligations of state and political subdivisions	-	84,694	-	84,694
Mortgage banking derivative - asset	-	2,021	-	2,021
Mortgage banking derivative - liability	-	(996)	-	(996)

There were no transfers between levels 1 and 2 for the three and nine months ended September 30, 2012 and 2011.

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
U.S. treasury bonds		2,010		2,010
Mortgage-backed - 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)

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 three and nine months ended September 30, 2012 and 2011:

Fair Value Measurements Using Significant Unobservable Inputs (Level 3)	
(In Thousands)	
Beginning balance, January 1, 2012	$1,342
Total gains or losses (realized/unrealized)	
Included in earnings (realized)	81
Included in other comprehensive income (presented gross of taxes)	151
Amortization	-
Redemption	(266)
Transfers in and/or out of Level 3	-
Ending balance, September 30, 2012	$1,308

Fair Value Measurements Using Significant Unobservable Inputs (Level 3)	
(In Thousands)	
Beginning balance, July 1, 2012	$1,227
Total gains or losses (realized/unrealized)	
Included in earnings (realized)	-
Included in other comprehensive income (presented gross of taxes)	81
Amortization	-
Redemption	-

Transfers in and/or out of Level 3	-
Ending balance, September 30, 2012	$1,308

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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 (unrealized)	(2)
Included in other comprehensive income (presented gross of taxes)	(133)
Amortization	4
Transfers in and/or out of Level 3	-
Ending balance, September 30, 2011	$1,367

Fair Value Measurements Using Significant Unobservable Inputs (Level 3)	
(In Thousands)	
Beginning balance, July 1, 2011	$1,538
Total gains or losses (realized/unrealized)	
Included in earnings (unrealized)	-
Included in other comprehensive income (presented gross of taxes)	(171)
Amortization	-
Transfers in and/or out of Level 3	-
Ending balance, September 30, 2011	$1,367

For Level 3 assets and liabilities measured at fair value on a recurring or nonrecurring basis as of September 30, 2012, the significant unobservable inputs used in the fair value measurements were as follows:

	Fair Value	Valuation Technique	Unobservable Inputs	Range of Inputs
	(Dollars in Thousands)			
Trust preferred stock	$1,308	Discounted cash flow	Constant prepayment rate	2-30%
			Expected asset default	0-30%
			Expected recoveries	0-15%
Impaired Loans- Applies to all loan classes	$1,258	Appraisals	Discounts for collection issues and changes in market conditions	0-10%
Real estate held for sale – Applies to all classes	$267	Appraisals	Discounts for changes in market conditions	0-20%

The following table summarizes the financial 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

September 30, 2012	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
	(In Thousands)			
Impaired loans				
Residential Loans	$-	$ -	$ 721	$ 721
Commercial Loans	-	-	-	-
Multi Family Loans	-	-	-	-
CRE loans	-	-	537	537
Total Impaired loans	-	-	1,258	1,258
Mortgage servicing rights	-	7,752	-	7,752
Real estate held for sale				
Residential	-	-	-	-
CRE	-	-	267	267
Total Real Estate held for sale	-	-	267	267

December 31, 2011	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
	(In Thousands)			
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
Real estate held for sale				
Residential	-	-	28	28
CRE	-	-	1,600	1,600
Total Real Estate held for sale	-	-	1,628	1,628

Impaired loans, which are measured for impairment using the fair value of the collateral for collateral dependent loans, had a fair value of $1.3 million, with a valuation allowance of $719,000 at September 30, 2012. Provision expense of $1.2 million for the three months ended September 30, 2012 was included in earnings. Provision expense of $5.4 million for the nine months ended September 30, 2012 was included in earnings.

Mortgage servicing rights which are carried at the lower of cost or fair value had a fair value of $7.8 million at September 30, 2012 resulting in a valuation allowance of $2.4 million. A charge of $600,000 for the three months and $855,000 for the nine months ended September 30, 2012 was included in earnings.

Real estate held for sale is determined using Level 3 inputs which include appraisals and are adjusted for estimated costs to sell. The change in fair value of real estate held for sale was $36,000 for the three months and $299,000 for the nine months ended September 30, 2012 which 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 $10.9 million, with a valuation allowance of $7.2 million at December 31, 2011. A provision expense of $717,000 for the three months and $6.2 million for the nine months ended September 30, 2011 were included in earnings.

Mortgage servicing rights that are carried at the lower of cost or fair value had a fair value of $8.7 million at December 31, 2011, resulting in a valuation allowance of $1.5 million. A charge of $1.1 million for the three months and $585,000 for the nine months ended September 30, 2011 were included in earnings.

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 $93,000 for the three months and $644,000 for the nine months ended September 30, 2011, which 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 September 30, 2012 and December 31, 2011. 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, term notes payable and advance payments by borrowers for taxes and insurance, as a result of their short-term nature, is considered to be equal to fair value and are classified as Level 1.

It was not practicable to determine the fair value of Federal Home Loan Bank (“FHLB”) stock due to restrictions placed on its transferability.

The fair value of loans that 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, resulting in a Level 3 classification. Impaired loans are valued at the lower of cost or fair value as previously described. The allowance for loan losses is considered to be a reasonable adjustment for credit risk. The methods utilized to estimate the fair value of loans do not necessarily represent an exit price. The fair value of loans held for sale is estimated based on binding contracts and quotes from third party investors resulting in a Level 2 classification.

The fair value of accrued interest receivable is equal to the carrying amounts resulting in a Level 2 or Level 3 classification which is consistent with its underlying asset.

The fair value of non-interest bearing deposits are considered equal to the amount payable on demand at the reporting date (i.e. carrying value) and are classified as Level 1. The fair value of savings, NOW and certain money market accounts are equal to their carrying amounts and are a Level 2 classification. Fair values of fixed rate certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities on time deposits resulting in a Level 2 classification.

The fair values of securities sold under repurchase agreements are equal to their carrying amounts resulting in a Level 2 classification. The carrying value of subordinated debentures and deposits with fixed maturities is estimated based on discounted cash flow analyses based on interest rates currently being offered on instruments with similar characteristics and maturities resulting in a Level 3 classification.

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 resulting in a Level 2 classification. The cost or value of any call or put options is based on the estimated cost to settle the option at September 30, 2012.

	Carrying	Fair Value Measurements at September 30, 2012 (In Thousands)			
	Value	Total	Level 1	Level 2	Level 3
Financial Assets:					
Cash and cash equivalents	$92,406	$92,406	$92,406	$-	$-
Investment securities	269,683	269,693	69	268,317	1,308
Federal Home Loan Bank Stock	20,655	N/A	N/A	N/A	N/A
Loans, net, including loans held for sale	1,498,023	1,518,395	-	12,201	1,505,707
Accrued interest receivable	6,819	6,819	-	1,434	5,385
Financial Liabilities:					
Deposits	$1,609,350	$1,614,570	$271,305	$1,343,265	$-
Advances from Federal Home Loan Bank	81,807	84,349	-	84,349	-
Securities sold under repurchase agreements	51,991	51,991	-	51,991	-
Subordinated debentures	36,083	44,530	-	-	44,530

	December 31, 2011	
	Carrying Value	Estimated Fair Values
Assets:		
Cash and cash equivalents	$174,931	$174,931
Investment securities	233,580	233,591
Federal Home Loan Bank Stock	20,655	N/A
Loans, net, including loans held for sale	1,467,663	1,494,573
Mortgage banking derivative asset	865	865
Accrued interest receivable	6,142	6,142
	1,903,836	$1,910,102
Other assets	164,354	
Total assets	$2,068,190	
Liabilities and stockholders' equity:		
Deposits	$1,596,241	$1,603,111
Advances from Federal Home Loan Bank	81,841	85,196
Securities sold under repurchase agreements	60,386	60,386
Subordinated debentures	36,083	31,814
Accrued interest payable	446	446
Mortgage banking derivative liability	258	258
Advance payments by borrowers for taxes and insurance	1,402	1,402
	1,776,399	$1,782,613
Other liabilities	13,664	
Total liabilities	1,790,063	
Stockholders' equity	278,127	
Total liabilities and stockholders' equity	$2,068,190	

4. Stock Compensation Plans

First Defiance has established equity based compensation 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 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 common shares through the award of options, stock grants, restricted stock units ("RSU"), stock appreciation rights or other stock-based awards.

As of September 30, 2012, 317,300 options have been granted pursuant to the 2010 equity plan and previous plans, 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 vested 40% in 2011 and then 20% annually. All options expire ten years from the 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 2011 Short-Term ("STIP") Equity Incentive Plan and a 2011 Long-Term ("LTIP") Equity Incentive Plan for selected members of management. The Plans were effective January 1, 2011 and provide for cash and/or equity benefits if certain performance targets are achieved. Equity awards issued under these plans will reduce the amount of the awards available to be issued under the 2010 Equity Plan.

On March 9, 2012, the Company approved a 2012 STIP and a 2012 LTIP for selected members of management. The plans were effective January 1, 2012 and provide for cash and/or equity benefits if certain performance targets are achieved. Equity awards issued under these plans will reduce the amount of awards available to be issued under the 2010 Equity Plan.

Under both STIPs the participants may earn up to 25% to 45% of their salary for potential payout based on the achievement of certain corporate and/or market area performance targets during the calendar year. The final value of the awards to be made under the 2012 STIP will be determined as of December 31 of each year and will be paid out in cash and/or equity, as elected by the participant, in accordance with the following vesting schedule: 50% in the first quarter after the calendar year, 25% on the one-year anniversary of the grant date, and 25% on the second-year anniversary. The participants are required to be employed on the day of payout in order to receive an award.

Under both LTIPs the participants may earn up to 25% to 45% of their salary for potential payout based on the achievement of certain corporate performance targets either over a two or three year period. The final amount of benefit under the 2011 LTIP will be determined as of December 31, 2012 and the final amount of benefit under the 2012 LTIP will be determined as of December 31, 2014. The benefits earned under the plans will be paid out in cash and/or equity, as elected by the participant, in the first quarter following the close of the performance period. The participants are required to be employed on the day of payout in order to receive the payment.

The fair value of each option award is estimated on the date of grant using the Black-Scholes model. Expected volatilities are based on historical volatilities of the Company's common shares. 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. There were no options granted during the nine months ended September 30, 2012 or 2011.

Following is activity under the plans during the nine months ended September 30, 2012:

Stock options	Options Outstanding	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value (in 000's)
Options outstanding, January 1, 2012	317,800	$ 20.35		
Forfeited or cancelled	-	-		
Exercised	500	9.22		
Granted	-	-		
Options outstanding, September 30, 2012	317,300	$ 20.37	4.15	$ 507
Vested or expected to vest at September 30, 2012	317,300	$ 20.37	4.15	$ 507
Exercisable at September 30, 2012	276,460	$ 21.53	3.83	$ 306

As of September 30, 2012, there was $62,000 of total unrecognized compensation costs related to unvested stock options granted under the Company's equity plans. The cost is expected to be recognized over a weighted-average period of 1.5 years.

At September 30, 2012, 5,681 stock grants and 38,871 RSU's were outstanding. Compensation expense is recognized over the performance period based on the achievements of established targets. Total expense of $554,000 was recorded during the nine months ended September 30, 2012 and approximately $394,000 is included within other liabilities at September 30, 2012 related to the STIPs and LTIPs.

	Restricted Stock Units		Stock Grants	
Unvested Shares	Shares	Weighted-Average Grant Date Fair Value	Shares	Weighted-Average Grant Date Fair Value
Unvested at January 1, 2012	27,108	$ 11.97	4,738	$ 14.00
Granted	27,714	15.86	13,044	12.76
Vested	(11,157)	11.97	(6,522)	12.76
Forfeited	(4,794)	11.97	-	-
Unvested at September 30, 2012	38,871	$ 14.74	11,260	$ 13.28

The maximum amount of compensation expense that may be recorded for the 2012 STIP and both LTIPs at September 30, 2012 is approximately $1.3 million. However, the estimated expense expected to be recorded as of September 30, 2012 based on the performance measures in the plans, is $1.0 million of which $479,000 is unrecognized at September 30, 2012 and will be recognized over the remaining performance period.

5. Dividends on Common Shares

First Defiance declared and paid a $0.05 per common stock dividend in the first, second and third quarter of 2012. There was no common stock dividend declared or paid in the first three quarters of 2011.

As a result of its participation in the Capital Purchase Program ("CPP"), First Defiance was 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. This prohibition ended when the U.S. Treasury sold all of its preferred stock on June 19, 2012. Further, First Defiance has agreed in its Memorandum of Understanding with the Federal Reserve to obtain the approval of the Federal Reserve prior to the declaration of dividends.

6. Earnings Per Common Share

The following table sets forth the computation of basic and diluted earnings per common share (in thousands except per share data):

	Three months ended September 30,		Nine months ended September 30,	
	2012	2011	2012	2011
Numerator for basic and diluted earnings per common share – Net income applicable to common shares	$ 5,423	$ 3,553	$ 12,891	$ 9,951
Denominator:				
Denominator for basic earnings per common share – weighted average common shares, including participating securities	9,729	9,725	9,728	9,248
Effect of warrants	223	151	215	151
Effect of restricted stock units	20	4	25	4
Effect of employee stock options	28	15	25	14
Denominator for diluted earnings per common share	10,000	9,895	9,993	9,417
Basic earnings per common share	$ 0.56	$ 0.37	$ 1.33	$ 1.08
Diluted earnings per common share	$ 0.54	$ 0.36	$ 1.29	$ 1.06

There were 233,700 and 234,643 shares under option granted to employees excluded from the diluted earnings per common share calculation as they were anti-dilutive for the three months and nine months ended September 30, 2012, respectively. Shares under option of 257,900 were excluded from the diluted earnings per common share calculations as they were anti-dilutive for the three and nine months ended September 30, 2011.

7. Investment Securities

The following is a summary of available-for-sale and held-to-maturity securities (in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
At September 30, 2012				
Available-for-Sale Securities:				
Obligations of U.S. government corporations and agencies	$ 21,497	$ 152	$ -	$ 21,649
U.S. treasury bonds	2,000	4	-	2,004
Mortgage-backed securities – residential	82,023	3,472	-	85,495
REMICs	-	-	-	-
Collateralized mortgage obligations	63,227	1,815	(12)	65,030
Trust preferred securities and preferred stock	3,604	35	(2,262)	1,377
Corporate bonds	8,695	167	(13)	8,849
Obligations of state and political subdivisions	77,945	6,754	(5)	84,694
Totals	$ 258,991	$ 12,399	$ (2,292)	$ 269,098
Held-to-Maturity Securities*:				
FHLMC certificates	$ 72	$ -	$ -	$ 72
FNMA certificates	173	6	-	179
GNMA certificates	63	3	-	66
Obligations of state and political subdivisions	277	1	-	278
Totals	$ 585	$ 10	$ -	$ 595
At December 31, 2011				
Available-for-Sale Securities:				
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	68,400	2,318	(2)	70,716
REMICs	2,863	31	-	2,894
Collateralized mortgage obligations	57,083	1,926	-	59,009
Trust preferred securities 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
Totals	$ 225,682	$ 10,034	$ (2,797)	$ 232,919
Held-to-Maturity Securities*:				
FHLMC certificates	$ 82	$ 1	$ -	$ 83
FNMA certificates	199	4	-	203
GNMA certificates	72	3	-	75
Obligations of state and political subdivisions	308	3	-	311

Totals	$ 661	$ 11	$ -	$ 672

* FHLMC, FNMA, and GNMA certificates are residential mortgage-backed securities.

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The amortized cost and fair value of the investment securities portfolio at September 30, 2012 are shown below by contractual maturity. Expected maturities will differ from contractual maturities because borrowers 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 (“MBS”), collateralized mortgage obligations (“CMO”) and REMICs, which are not due at a single maturity date, have not been allocated over the maturity groupings. These securities may mature earlier than their weighted-average contractual maturities because of principal prepayments.

	Available-for-Sale		Held-to-Maturity	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
	(In Thousands)			
Due in one year or less	$2,595	$2,602	$ 60	$ 61
Due after one year through five years	15,056	15,331	-	-
Due after five years through ten years	39,530	41,614	217	217
Due after ten years	56,560	59,026	-	-
MBS/CMO/REMIC	145,250	150,525	308	317
	$258,991	$269,098	$ 585	$ 595

Investment securities with a carrying amount of $139.6 million at September 30, 2012 were pledged as collateral on public deposits, securities sold under repurchase agreements and FHLB advances.

As of September 30, 2012, the Company’s investment portfolio consisted of 378 securities, 19 of which were in an unrealized loss position.

The following tables summarize First Defiance’s securities that were in an unrealized loss position at September 30, 2012 and December 31, 2011:

	Duration of Unrealized Loss Position					
	Less than 12 Months		12 Month or Longer		Total	
	Fair Value	Gross Unrealized Loss	Fair Value	Gross Unrealized Loss	Fair Value	Unrealized Losses
	(In Thousands)					
At September 30, 2012						
Available-for-sale securities:						
Mortgage-backed - residential	$1	$ -	$ -	$ -	$1	$ -
Collateralized mortgage obligations and REMICs	4,610	(12)	-	-	4,610	(12)
Corporate bonds	-	-	1,908	(13)	1,908	(13)

Trust preferred stock and preferred stock	-	-	1,308	(2,262)	1,308	(2,262)
Obligations of state and political subdivisions	1,514	(5)	-	-	1,514	(5)
Total temporarily impaired securities	$6,125	$ (17)	$ 3,216	$ (2,275)	$9,341	$ (2,292)

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	Duration of Unrealized Loss Position					
	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Gross Unrealized Loss	Fair Value	Gross Unrealized Loss	Fair Value	Unrealized Loses
	(In Thousands)					
At December 31, 2011						
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)

With the exception of Trust Preferred Securities, 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. 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 of investment securities totaled $103,000 ($67,000 after tax) in the third quarter of 2012 while there were no realized gains in the third quarter of 2011. Realized gains from the sales of investment securities totaled $528,000 ($343,000 after tax) for the first nine months of 2012 compared to realized gains of $49,000 ($32,000 after tax) for the first nine months of 2011.

Management evaluates securities for other-than-temporary impairment (“OTTI”) at least quarterly, and more frequently 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.

For the first nine months of 2012, management determined there was no OTTI. For the first nine months of 2011, management determined there was OTTI on one CDO resulting in a write-down of $2,200 ($1,400 after tax).

The Company held eight CDOs at September 30, 2012. Four of those CDOs were written down in full prior to January 1, 2010. The remaining four CDOs have a total amortized cost of $3.6 million at September 30, 2012. Of these, two, with a total amortized cost of $1.6 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 June 2012, the Company was notified that its Preferred Term Security VI was redeemed through an auction process. The security was redeemed at full price with proceeds being received in July 2012. This security had previously identified OTTI of $80,000. The previous OTTI amount was recorded as a yield adjustment in interest income in June 2012 due to the increase in expected cash flows resulting from the auction.

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.

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 make 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.

The following table details the six securities with OTTI, their lowest credit rating at September 30, 2012 and the related credit losses recognized in earnings for the three month periods ended March 31, 2012, June 30, 2012, and September 30, 2012 (In Thousands):

	TPREF Funding II Rated Caa3	Alesco VIII Rated Ca	Preferred Term Security XXVII Rated C	Trapeza CDO I Rated Ca	Alesco Preferred Funding VIII Not Rated	Alesco Preferred Funding IX Not Rated	Total
Cumulative OTTI related to credit loss at January 1, 2012	$ 318	$ 1,000	$ 78	$ 857	$ 453	$ 465	$3,171
Addition – Qtr 1	-	-	-	-	-	-	-
Cumulative OTTI related to credit loss at March 31, 2012	$ 318	$ 1,000	$ 78	$ 857	$ 453	$ 465	$3,171
Addition – Qtr 2	-	-	-	-	-	-	-
Cumulative OTTI related to credit loss at June 30, 2012	$ 318	$ 1,000	$ 78	$ 857	$ 453	$ 465	$3,171
Addition – Qtr 3	-	-	-	-	-	-	-
Cumulative OTTI related to credit loss at September 30, 2012	$ 318	$ 1,000	$ 78	$ 857	$ 453	$ 465	$3,171

The amount of OTTI recognized in accumulated other comprehensive income ("AOCI") was $747,000 for the above securities at September 30, 2012. There was $854,000 recognized in AOCI at September 30, 2011.

The following table provides additional information related to the four CDO investments for which a balance remains as of September 30, 2012 (dollars in thousands):

CDO	Class	Amortized Cost	Fair Value	Unrealized Loss	OTTI Losses 2012	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
TPREF Funding II	B	$ 677	$ 225	$ (452)	-	Caa3	17	38.81 %	15.53 %	-
I-Preferred Term Sec I	B-1	1,000	456	(544)	-	CCC	14	17.24 %	14.70 %	27.44 %
Dekania II CDO	C-1	990	421	(569)	-	CCC	32	- %	13.87 %	29.18 %
Preferred Term Sec XXVII	C-1	903	206	(697)	-	Ca	34	26.68 %	22.84 %	6.09 %
Total		$ 3,570	$ 1,308	$ (2,262)	$ -					

The Company’s assumed average lifetime default rate declined from 29.7% at the end of the third quarter 2011 to a rate of 28.4% at the end of the third quarter 2012.

The table below presents a roll-forward of the credit losses relating to debt securities recognized in earnings for the three and nine month periods ended September 30, 2012 and 2011 (in thousands):

	Three Months Ended September 30, 2012	Three Months Ended September 30, 2011	Nine Months Ended September 30, 2012	Nine Months Ended September 30, 2011
Beginning balance	$ 3,171	$ 3,251	$ 3,251	$ 3,249
Additions for amounts related to credit loss for which an OTTI was not previously recognized	-	-	-	-
Reductions for amounts realized for securities sold/redeemed during the period	-	-	(80)	-
Reductions for amounts related to securities for which the Company intends to sell or that it will be more than 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
Ending balance	$ 3,171	$ 3,251	$ 3,171	$ 3,251

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	(In thousands)		(In thousands)	
Proceeds	$ 2,122	$ -	$ 8,538	$ 1,982
Gross realized gains	103	-	528	49
Gross realized losses	-	-	-	-

The following table summarizes the changes within each classification of accumulated other comprehensive income for the quarters ended September 30, 2012 and 2011:

	Unrealized gains (losses) on available for sale securities	Postretirement Benefit	Accumulated other comprehensive income (loss), net
	(In Thousands)		
Balance at December 31, 2011	$4,704	$ (707)	$ 3,997
Other comprehensive income (loss), net	1,866	-	1,866
Balance at September 30, 2012	$6,570	$ (707)	$ 5,863

	Unrealized gains (losses) on available for sale securities	Postretirement Benefit	Accumulated other comprehensive income (loss), net
	(In Thousands)		
Balance at December 31, 2010	$32	$ (374)	$ (342)
Other comprehensive income (loss), net	4,521	-	4,521
Balance at September 30, 2011	$4,553	$ (374)	$ 4,179

8. Loans

Loans receivable consist of the following (in thousands):

	September 30, 2012	December 31, 2011
Real Estate:		
Secured by 1-4 family residential	$ 210,053	$ 203,401
Secured by multi-family residential	119,968	126,246
Secured by commercial real estate	672,383	649,746
Construction	31,428	31,552
	1,033,832	1,010,945
Other Loans:		
Commercial	365,510	349,053
Home equity and improvement	111,563	122,143
Consumer Finance	16,785	18,887
	493,858	490,083
Total loans	1,527,690	1,501,028
Deduct:		
Undisbursed loan funds	(14,831)	(13,243)
Net deferred loan origination fees and costs	(727)	(709)
Allowance for loan loss	(26,310)	(33,254)
Totals	$ 1,485,822	$ 1,453,822

Loan segments have been identified by evaluating the portfolio based on collateral and credit risk characteristics.

The following table discloses allowance for loan loss activity for the quarter ended September 30, 2012 and September 30, 2011 by portfolio segment and impairment method (in thousands):

Quarter Ended September 30, 2012	1-4 Family Residential Real Estate	Construction	Multi- Family Residential Real Estate	Commercial Real Estate	Commercial	Home Equity and Improvement	Consumer	Total
Beginning Allowance	$ 3,104	$ 46	$ 2,610	$ 13,914	$ 5,156	$ 1,435	$ 144	$ 26,409
Charge-Offs	(217)	-	-	(780)	(355)	(203)	(19)	(1,574)
Recoveries	26	-	122	430	140	38	14	770
Provisions	83	17	(261)	225	162	471	8	705
Ending Allowance	$ 2,996	$ 63	$ 2,471	$ 13,789	$ 5,103	$ 1,741	$ 147	$ 26,310

		Construction			Commercial		Consumer	Total

Quarter Ended September 30, 2011	1-4 Family Residential Real Estate		Multi- Family Residential Real Estate	Commercial Real Estate		Home Equity and Improvement		
Beginning Allowance	$ 5,930	$ 47	$ 1,943	$ 22,444	$ 8,290	$ 1,639	$ 227	$ 40,530
Charge-Offs	(647)	-	(78)	(2,544)	(2,533)	(290)	(36)	(6,128)
Recoveries	38	-	-	185	342	35	11	611
Provisions	(1,298)	22	762	1,801	1,705	88	17	3,097
Ending Allowance	$ 4,023	$ 69	$ 2,637	$ 21,886	$ 7,804	$ 1,472	$ 219	$ 38,110

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The following table discloses allowance for loan loss activity year to date as of September 30, 2012 and 2011 by portfolio segment and impairment method (in thousands):

Year to Date September 30, 2012	1-4 Family Residential Real Estate	Construction	Multi- Family Residential Real Estate	Commercial Real Estate	Commercial	Home Equity and Improvement	Consumer	Total
Beginning Allowance	$ 4,095	$ 63	$ 2,850	$ 17,640	$ 6,576	$ 1,856	$ 174	$ 33,254
Charge-Offs	(1,539)	-	(555)	(10,170)	(3,507)	(668)	(74)	(16,513)
Recoveries	150	-	122	574	295	77	45	1,263
Provisions	290	-	54	5,745	1,739	476	2	8,306
Ending Allowance	$ 2,996	$ 63	$ 2,471	$ 13,789	$ 5,103	$ 1,741	$ 147	$ 26,310

Year-to-Date September 30, 2011	1-4 Family Residential Real Estate	Construction	Multi- Family Residential Real Estate	Commercial Real Estate	Commercial	Home Equity and Improvement	Consumer	Total
Beginning Allowance	$ 5,956	$ 73	$ 2,147	$ 20,208	$ 10,871	$ 1,528	$ 297	$ 41,080
Charge-Offs	(2,087)	-	(442)	(5,971)	(2,975)	(801)	(67)	(12,343)
Recoveries	56	-	-	497	374	56	55	1,038
Provisions	98	(4)	932	7,152	(466)	689	(66)	8,335
Ending Allowance	$ 4,023	$ 69	$ 2,637	$ 21,886	$ 7,804	$ 1,472	$ 219	$ 38,110

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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 September 30, 2012:

(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	$ 191	$ -	$ -	$ 520	$ -	$ 8	$ -	$719
Collectively evaluated for impairment	2,805	63	2,471	13,269	5,103	1,733	147	25,591
Acquired with deteriorated credit quality	-	-	-	-	-	-	-	-
Total ending allowance balance	$ 2,996	$ 63	$ 2,471	$ 13,789	$ 5,103	$ 1,741	$ 147	$26,310
Loans:								
Loans individually evaluated for impairment	$ 8,715	$ -	$ 1,181	$ 33,868	$ 6,427	$ 36	$ -	$50,227
Loans collectively evaluated for impairment	201,875	16,582	118,918	640,397	360,321	112,029	16,790	1,466,912

Loans acquired with deteriorated credit quality	38	-	-	289	46	-	-	373
Total ending loans balance	$ 210,628	$ 16,582	$ 120,099	$ 674,554	$ 366,794	$ 112,065	$ 16,790	$ 1,517,512

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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

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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 September 30, 2012			Nine Months Ended September 30, 2012		
	Average Balance	Interest Income Recognized	Cash Basis Income Recognized	Average Balance	Interest Income Recognized	Cash Basis Income Recognized
Residential Owner Occupied	$ 1,912	15	$ 14	$ 1,921	$ 45	$ 42
Residential Non Owner Occupied	6,141	54	58	5,397	126	129
Total Residential Real Estate	8,053	69	72	7,318	171	171
Construction	-	-	-	-	-	-
Multi-Family	811	10	10	627	11	11
CRE Owner Occupied	12,414	53	44	11,019	92	88
CRE Non Owner Occupied	14,881	104	161	15,231	284	287
Agriculture Land	773	6	1	1,107	20	15
Other CRE	5,987	1	1	7,015	4	4
Total Commercial Real Estate	34,055	164	207	34,372	400	394
Commercial Working Capital	2,048	9	11	2,005	13	15
Commercial Other	4,188	25	26	4,538	40	42
Total Commercial	6,236	34	37	6,543	53	57
Consumer	-	-	-	-	-	-
Home Equity and Home Improvement	36	-	-	37	2	2
Total Impaired Loans	$ 49,191	$ 277	$ 326	$ 48,897	$ 637	$ 635

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 September 30, 2011			Nine Months Ended September 30, 2011		
	Average Balance	Interest Income Recognized	Cash Basis Income Recognized	Average Balance	Interest Income Recognized	Cash Basis Income Recognized
Residential Owner Occupied	$ 2,224	$ 14	$ 14	$ 2,763	$ 53	$ 51
Residential Non Owner Occupied	2,249	28	28	2,656	64	68
Total Residential Real Estate	4,473	42	42	5,419	117	119
Construction	-	-	-	31	-	-
Multi-Family	1,836	16	16	2,263	73	67
CRE Owner Occupied	10,210	52	55	11,340	267	249
CRE Non Owner Occupied	19,830	184	183	19,950	674	624
Agriculture Land	1,773	17	16	2,072	39	39
Other CRE	8,483	10	7	7,869	51	42
Total Commercial Real Estate	40,296	263	261	41,231	1,031	954
Commercial Working Capital	3,346	21	21	4,260	68	71
Commercial Other	9,012	40	39	10,745	180	179
Total Commercial	12,358	61	60	15,005	248	250
Consumer	-	-	-	-	-	-
Home Equity and Home Improvement	311	4	3	313	11	11
Total Impaired Loans	$ 59,274	$ 386	$ 382	$ 64,262	$ 1,480	$ 1,401

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The following table presents loans individually evaluated for impairment by class of loans as of September 30, 2012:
(In Thousands)

	Unpaid Principal Balance*	Recorded Investment	Allowance for Loan Losses Allocated
With no allowance recorded:			
Residential Owner Occupied	$ 949	$ 918	$ -
Residential Non Owner Occupied	7,709	6,934	-
Total Residential Real Estate	8,658	7,852	-
Construction	-	-	-
Multi-Family Residential Real Estate	1,346	1,181	-
CRE Owner Occupied	14,643	11,545	-
CRE Non Owner Occupied	17,272	15,235	-
Agriculture Land	1,159	961	-
Other CRE	9,694	5,359	-
Total Commercial Real Estate	42,768	33,100	-
Commercial Working Capital	2,378	2,292	-
Commercial Other	5,899	4,181	-
Total Commercial	8,277	6,473	-
Consumer	-	-	-
Home Equity and Home Improvement	16	16	-
Total loans with no allowance recorded	$ 61,065	$ 48,622	$ -
With an allowance recorded:			
Residential Owner Occupied	$ 969	$ 902	$ 191
Residential Non Owner Occupied	-	-	-
Total Residential Real Estate	969	902	191
Construction	-	-	-
Multi-Family Residential Real Estate	-	-	-
CRE Owner Occupied	1,007	834	376
CRE Non Owner Occupied	585	222	144
Agriculture Land	-	-	-
Other CRE	-	-	-
Total Commercial Real Estate	1,592	1,056	520
Commercial Working Capital	-	-	-
Commercial Other	-	-	-
Total Commercial	-	-	-
Consumer	-	-	-
Home Equity and Home Improvement	20	20	8
Total loans with an allowance recorded	$ 2,581	$ 1,978	$ 719

* Presented gross of charge offs

Impaired loans have been recognized in conformity with FASB ASC Topic 310.

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
With no allowance recorded:			
Residential Owner Occupied	$ 981	$ 984	$ -
Residential Non Owner Occupied	1,871	1,877	-
Total Residential Real Estate	2,852	2,861	-
Construction	-	-	-
Multi-Family Residential Real Estate	1,138	1,137	-
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	-
Total Commercial Real Estate	20,955	20,978	-
Commercial Working Capital	1,391	1,393	-
Commercial Other	3,444	3,453	-
Total Commercial	4,835	4,846	-
Consumer	-	-	-
Home Equity and Home Improvement	39	40	-
Total loans with no allowance recorded	$ 29,819	$ 29,862	$ -
With an allowance recorded:			
Residential Owner Occupied	$ 1,020	$ 1,020	$ 373
Residential Non Owner Occupied	726	726	281
Total Residential Real Estate	1,746	1,746	654
Construction	-	-	-
Multi-Family Residential Real Estate	298	298	195
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
Total Commercial Real Estate	13,849	13,856	5,400
Commercial Working Capital	358	358	192
Commercial Other	1,879	1,881	777
Total Commercial	2,237	2,239	969
Consumer	-	-	-
Home Equity and Home Improvement	-	-	-
Total loans with an allowance recorded	$ 18,130	$ 18,139	$ 7,218

* Presented net of charge-offs

The following table presents the aggregate amounts of non-performing assets, comprised of non-performing loans and real estate owned on the dates indicated:

	September 30, 2012	December 31, 2011
	(in thousands)	
Non-accrual loans	$37,803	$ 39,328
Loans over 90 days past due and still accruing	-	-
Troubled debt restructuring, still accruing	4,305	3,380
Total non-performing loans	42,108	$ 42,708
Real estate and other assets held for sale	2,843	3,628
Total non-performing assets	$44,951	$ 46,336

The following table presents the aging of the recorded investment in past due and non accrual loans as of September 30, 2012 by class of loans: *(In Thousands)*

	Current	30-59 days	60-89 days	90+ days	Total Past Due	Total Non Accrual
Residential Owner Occupied	$131,214	$1,573	$549	$1,161	$3,283	$1,589
Residential Non Owner Occupied	72,958	598	1,063	1,512	3,173	4,196
Total residential real estate	204,172	2,171	1,612	2,673	6,456	5,785
Construction	16,582	-	-	-	-	-
Multi-Family	120,062	-	-	37	37	727
CRE Owner Occupied	317,578	2,637	1,306	1,888	5,831	9,971
CRE Non Owner Occupied	238,125	16	107	2,713	2,836	8,422
Agriculture Land	71,714	353	139	148	640	975
Other Commercial Real Estate	34,114	-	-	3,716	3,716	4,885
Total Commercial Real Estate	661,531	3,006	1,552	8,465	13,023	24,253
Commercial Working Capital	158,180	209	115	1,067	1,391	1,942
Commercial Other	204,184	382	880	1,777	3,039	4,733
Total Commercial	362,364	591	995	2,844	4,430	6,675
Consumer	16,657	105	13	15	133	15
Home Equity / Home Improvement	110,042	1,458	222	343	2,023	343
Total Loans	$1,491,410	$7,331	$4,394	$14,377	$26,102	$37,798

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

	Current	30-59 days	60-89 days	90+ days	Total Past Due	Total Non Accrual
Residential Owner Occupied	$131,014	$1,573	$220	$1,996	$3,789	$2,490
Residential Non Owner Occupied	67,516	563	410	768	1,741	1,397
Total residential real estate	198,530	2,136	630	2,764	5,530	3,887
Construction	18,288	-	-	-	-	-
Multi-Family	125,050	1,022	-	443	1,465	443
CRE Owner Occupied	288,096	1,468	993	4,771	7,232	7,691
CRE Non Owner Occupied	243,016	921	1,990	3,384	6,295	10,398
Agriculture Land	70,490	-	-	456	456	1,275
Other Commercial Real Estate	30,056	98	-	5,951	6,049	8,342
Total Commercial Real Estate	631,658	2,487	2,983	14,562	20,032	27,706
Commercial Working Capital	137,310	-	223	242	465	1,410
Commercial Other	209,187	278	59	2,933	3,270	5,481
Total Commercial	346,497	278	282	3,175	3,735	6,891
Consumer	18,736	129	35	10	174	10
Home Equity / Home Improvement	119,400	2,602	267	394	3,263	394
Total Loans	$1,458,159	$8,654	$4,197	$21,348	$34,199	$39,331

Troubled Debt Restructurings

The Company has allocated $166,000 and $1.8 million, respectively, of specific reserves to customers whose loan terms have been modified in troubled debt restructurings ("TDRs") as of September 30, 2012 and December 31, 2011. The Company had not committed to lend any additional amounts to customers with outstanding loans that are classified as TDRs as of September 30, 2012 and had committed to lend additional amounts totaling up to $64,000 as of December 31, 2011.

The Company offers various types of concessions when modifying a loan, however, forgiveness of principal is rarely granted. Each TDR is uniquely designed to meet the specific needs of the borrower. Commercial and industrial loans modified in a TDR often involve temporary interest-only payments, term extensions, and converting revolving credit lines to term loans. Additional collateral or an additional guarantor is often requested when granting a concession. Commercial mortgage loans modified in a TDR often involve temporary interest-only payments, re-amortization of remaining debt in order to lower payments, and sometimes reducing the interest rate lower than the current market rate. Residential mortgage loans modified in a TDR are comprised of loans where monthly payments are lowered, either through interest rate reductions or principal only payments for a period of time, to accommodate the borrowers' financial needs, interest is capitalized into principal, or the term and amortization are extended. Home equity modifications are made infrequently and usually involve providing an interest rate that is lower than the borrower would be able to obtain due to credit issues.

A majority of the loans modified in a TDR are already on non-accrual status and partial charge-offs have in some cases already been taken against the outstanding balance. Loans modified as a TDR may have the financial effect of increasing the allowance associated with the loan. If the loan is determined to be collateral dependent, the estimated fair value of the collateral, less any selling costs is used to determine if there is a need for a specific allowance or charge-off. If the loan is determined to be cash flow dependent, the allowance is measured based on the present value of expected future cash flows discounted at the loan's effective interest rate.

The following table presents loans by class modified as TDRs that occurred during the three and nine month period ending September 30, 2012 (Dollars In Thousands):

	Loans Modified as a TDR for the Three Months Ended September 30, 2012			Loans Modified as a TDR for the Nine Months Ended September 30, 2012		
Troubled Debt Restructurings	Number of Loans	Recorded Investment (as of Period End)	Increase /(Decrease) in the Allowance (as of Period End)	Number of Loans	Recorded Investment (as of Period End)	Increase /(Decrease) in the Allowance (as of Period End)
Residential Owner Occupied	2	$ 221	$ (11)	7	$ 778	$ (5)
Residential Non Owner Occupied	1	34	-	2	116	-
CRE Owner Occupied	3	565	-	5	1,461	-
CRE Non Owner Occupied	1	217	(6)	1	217	(6)
Agriculture Land	1	127	-	2	439	(7)
Other CRE	-	-	-	1	61	(2)
Commercial / Industrial	2	34	-	2	34	(1)
Home Equity / Improvement	-	-	-	-	-	-
Total	10	$ 1,198	$ (17)	20	$ 3,106	$ (21)

The TDRs described above decreased the allowance for loan losses by $17,000 for the quarter ended September 30, 2012, after $64,000 of charge-offs during the quarter ended September 30, 2012. During the nine months ended September 30, 2012, the TDRs described above decreased the allowance for loan losses by $21,000 after $1.5 million of charge-offs.

The following table presents loans by class modified as TDRs that occurred during the period ending September 30, 2011 (Dollars In Thousands):

	Loans Modified as a TDR for the Three Months Ended September 30, 2011	Loans Modified as a TDR for the Nine Months Ended September 30, 2011

Troubled Debt Restructurings	Number of Loans	Recorded Investment (as of Period End)	Increase /(Decrease) in the Allowance (as of Period End)	Number of Loans	Recorded Investment (as of Period End)	Increase in the Allowance (as of Period End)
Residential Owner Occupied	1	$ 13	$ -	2	$ 29	$ -
CRE Owner Occupied	2	553	-	3	698	434
CRE Non Owner Occupied	3	3,433	240	4	5,148	1,397
Home Equity / Improvement	1	23	(7)	1	23	-
Total	7	$ 4,022	$ 233	10	$ 5,898	$ 1,831

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The TDRs described above increased the allowance for loan losses by $233,000 and $1.8 million for the three and nine months ending September 30, 2011, and resulted in $78,000 of charge offs during the three and nine months ending September 30, 2011.

There were five loans that defaulted during 2012 which had been modified within one year of the default date. A default for purposes of this disclosure is a TDR loan in which the borrower is 90 days past due. The recorded investment on these five loans was $1.7 million at September 30, 2012. There was no allowance for loan loss impact as a result of these defaults as they were already classified as collateral dependent and written down according to the fair value of their respective collateral.

The terms of certain other loans were modified during the period ending September 30, 2012 that did not meet the definition of a TDR. The modification of these loans involved a modification of the terms of a loan to borrowers who were not experiencing financial difficulties. A total of 256 loans were modified under this definition during the nine month period ended September 30, 2012.

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.

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.

Not Graded. Loans classified as not graded are generally smaller balance residential real estate, home equity and consumer installment loans which are originated primarily by using an automated underwriting system. These loans are monitored based on their delinquency status and are evaluated individually only if they are seriously delinquent.

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 September 30, 2012, 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	$4,096	$43	$ 4,495	-	$125,863	$134,497
Residential Non Owner Occupied	56,705	2,304	10,675	-	6447	76,131
Total residential real estate	60,801	2,347	15,170	-	132,310	210,628
Construction	9,484	-	-	-	7,098	16,582
Multi Family	115,662	927	2,469	-	1,041	120,099
CRE Owner Occupied	292,529	9,875	18,489	-	2,516	323,409
CRE Non Owner Occupied	208,354	3,654	28,839	-	114	240,961
Agriculture Land	69,543	1,260	1,551	-	-	72,354
Other CRE	29,458	497	6,949	-	926	37,830
Total Commercial Real Estate	599,884	15,286	55,828	-	3,556	674,554
Commercial Working Capital	150,303	4,891	4,377	-	-	159,571
Commercial Other	191,707	6,278	9,238	-	-	207,223
Total Commercial	342,010	11,169	13,615	-	-	366,794
Consumer	-	-	63	-	16,727	16,790
Home Equity/Improvement	-	-	898	-	111,167	112,065
Total	$1,127,841	$29,729	$ 88,043	-	$271,899	$1,517,512

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
Total residential real estate	54,149	3,170	12,791	-	133,951	204,061
Construction	13,417	-	127	-	4,744	18,288
Multi Family	117,699	3,519	4,186	-	1,111	126,515
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
Total Commercial Real Estate	555,074	21,858	73,380	-	1,377	651,689
Commercial Working Capital	125,149	6,125	6,501	-	-	137,775
Commercial Other	182,964	10,328	19,165	-	-	212,457
Total Commercial	308,113	16,453	25,666	-	-	350,232
Consumer	-	-	63	10	18,837	18,910
Home Equity/Improvement	-	-	1,734	-	120,928	122,662
Total	$1,048,452	$45,000	$ 117,947	$ 10	$280,948	$1,492,357

9. Mortgage Banking

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	(in thousands)		(in thousands)	
Gain from sale of mortgage loans	$ 2,888	$ 2,128	$ 7,890	$ 3,954
Mortgage loans servicing revenue (expense):				
Mortgage loans servicing revenue	824	852	2,499	2,529
Amortization of mortgage servicing rights	(892)	(553)	(2,610)	(1,349)
Mortgage servicing rights valuation adjustments	(600)	(1,072)	(855)	(585)
	(668)	(773)	(966)	595
Net revenue from sale and servicing of mortgage loans	$ 2,220	$ 1,355	$ 6,924	$ 4,549

The unpaid principal balance of residential mortgage loans serviced for third parties was $1.3 billion for September 30, 2012 and December 31, 2011.

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Activity for capitalized mortgage servicing rights and the related valuation allowance follows for the three and six months ended September 30, 2012 and 2011:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	(in thousands)		(in thousands)	
Mortgage servicing assets:				
Balance at beginning of period	$ 10,059	$ 10,477	$ 10,219	$ 10,602
Loans sold, servicing retained	969	446	2,527	1,117
Amortization	(892)	(553)	(2,610)	(1,349)
Carrying value before valuation allowance at end of period	10,136	10,370	10,136	10,370
Valuation allowance:				
Balance at beginning of period	(1,784)	(638)	(1,529)	(1,125)
Impairment recovery (charges)	(600)	(1,072)	(855)	(585)
Balance at end of period	(2,384)	(1,710)	(2,384)	(1,710))
Net carrying value of MSRs at end of period	$ 7,752	$ 8,660	$ 7,752	$ 8,660
Fair value of MSRs at end of period	$ 7,752	$ 8,660	$ 7,752	$ 8,660

Amortization of mortgage servicing rights is computed based on payments and payoffs of the related mortgage loans serviced.

10. Deposits

A summary of deposit balances is as follows (in thousands):

	September 30, 2012	December 31, 2011
Non-interest-bearing checking accounts	$ 271,305	$ 245,927
Interest-bearing checking and money market accounts	636,510	609,057
Savings accounts	166,155	155,101
Retail certificates of deposit less than $100,000	356,369	387,607
Retail certificates of deposit greater than $100,000	176,725	187,913
Brokered or national certificates of deposit	2,286	10,636
Total	$ 1,609,350	$ 1,596,241

11. Borrowings

First Defiance's debt, FHLB advances and junior subordinated debentures owed to unconsolidated subsidiary trusts are comprised of the following:

	September 30, 2012	December 31, 2011
	(in thousands)	
FHLB Advances:		
Overnight borrowings	$-	$ -
Single maturity fixed rate advances	20,000	20,000
Putable advances	44,000	44,000
Strike-rate advances	17,000	17,000
Amortizable mortgage advances	807	841
Total	$81,807	$ 81,841
Junior subordinated debentures owed to unconsolidated subsidiary trusts	$36,083	$ 36,083

The putable advances can be put back to the Company at the option of the FHLB on a quarterly basis. $14.0 million of the putable advances with a weighted average rate of 2.69% are not yet callable by the FHLB. The call dates for these advances range from October 15, 2012 to December 12, 2012 and the maturity dates range from February 11, 2013 to March 12, 2018. The FHLB has the option to call the remaining $30.0 million of putable advances with a weighted average rate of 4.76%. The maturity dates of these advances range from October 28, 2013 to January 14, 2015. The strike-rate advances are putable at the option of the FHLB only when the three month LIBOR rates exceed the agreed upon strike-rate in the advance contract which ranges from 7.5% to 8.0%. The three month LIBOR rate at September 30, 2012 was 0.36%. The weighted average rate of the strike-rate advances is 3.61% and the maturity dates range from October 15, 2012 to February 25, 2013.

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 this 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 1.50% points, repricing quarterly, thereafter. The rate switched to the floating interest rate on June 15, 2012 and as of September 30, 2012 the rate was 1.86%.

The Company also sponsored 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 1.74% and 1.73% on September 30, 2012 and December 31, 2011 respectively.

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

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.

12. Commitments, Guarantees and Contingent Liabilities

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 as of the periods stated below were as follows (in thousands):

	September 30, 2012		December 31, 2011	
	Fixed Rate	Variable Rate	Fixed Rate	Variable Rate
Commitments to make loans	$55,313	$ 45,969	$38,399	$ 47,037
Unused lines of credit	26,074	225,393	24,943	184,446
Standby letters of credit	-	20,621	4,600	21,507
Total	$81,387	$ 291,983	$67,942	$ 252,990

Commitments to make loans are generally made for periods of 60 days or less.

In addition to the above commitments, First Defiance had commitments to sell $63.1 million and $34.5 million of loans to Freddie Mac, Fannie Mae, Federal Home Loan Bank of Cincinnati or BB&T Mortgage at September 30, 2012 and December 31, 2011, respectively.

13. Income Taxes

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 2009. The Company currently operates primarily in the states of Ohio and Michigan, which tax financial institutions based on their equity rather than their income.

14. 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 $52.3 million and $21.7 million of interest rate lock commitments at September 30, 2012 and December 31, 2011, respectively. There were $63.1 million and $34.4 million of forward commitments for the future delivery of residential mortgage loans at September 30, 2012 and December 31, 2011, respectively.

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

	September 30, 2012			December 31, 2011		
	Assets	(Liabilities)		Assets	(Liabilities)	
	Carrying Value	Carrying Value	Derivative Net Carrying Value	Carrying Value	Carrying Value	Derivative Net Carrying Value
	(In Thousands)					

Derivatives not designated as hedging instruments						
Mortgage Banking Derivatives	$2,021	$ (996)	$ 1,025	$865	$ (258)	$ 607

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	(In Thousands)		(In Thousands)	
Derivatives not designated as hedging instruments				
Mortgage Banking Derivatives – Gain (Loss)	$ 28	$ 734	$ 418	$ 782

The above amounts are included in mortgage banking income with gain on sale of mortgage loans.

15. Acquisition

On July 1, 2011, First Defiance acquired Payak-Dubbs Insurance Agency, Inc. ("PDI"), 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 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. The customer relationship and non-compete intangibles were $736,000 and $389,000, respectively, at September 30, 2012. A contingent payable of $626,000 was also recorded in the transaction and is still outstanding at September 30, 2012. 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.

16. TARP Repurchase

In June 2012, the U.S. Treasury sold its preferred stock of the Company through a public offering structured as a modified Dutch auction. The Company bid on its preferred stock in the auction after receiving approval from its regulators. The clearing price per share for the preferred shares was $962.66 (compared to a par value of $1,000.00 per share) and the Company was successful in repurchasing 16,560 of the 37,000 preferred shares outstanding through the auction process. The Company successfully acquired an additional 19,440 preferred shares in the secondary market prior to the end of the second quarter. The clearing prices per share for the preferred shares purchased in the secondary market were as follows: 1,100 shares at $997.50, 1,500 shares at $1,000.00 and 16,840 shares at $998.75. The Company set up a payable for 16,840 of the 19,440 shares of $16.9 million at the end of the quarter as these shares did not settle until July 2, 2012.

On July 18, 2012, the Company purchased the remaining 1,000 preferred shares at par value to complete the entire repurchase of the 37,000 preferred shares. .

The net balance sheet impact was a reduction to stockholders' equity of $36.4 million which is comprised of a decrease in preferred stock of $37.0 million and a $642,000 increase to retained earnings related to the discount on the shares repurchased, which is also included in net income applicable to common shares for purposes of calculating earnings per share.

Included in the 2012 operating results is $181,000 of costs incurred by the Company related to the U.S. Treasury's offering. All these costs were incurred in the second quarter of 2012. These costs are not tax-deductible.

17. Balance Sheet Restructure

In October 2012, the Company executed a balance sheet restructuring strategy to enhance the Company's current and future profitability while increasing its capital ratios and protecting the balance sheet from rising rates. The strategy required taking an after tax loss of approximately $260,000 through selling $60 million in securities for a gain of $1.6 million and paying off $62 million in FHLB advances with a prepayment penalty of $2.0 million. The ongoing positive effects of this strategy: 1) increases the net interest margin and net interest income, 2) improves all capital ratios and 3) increases return on average assets and return on average equity.

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

Forward-Looking Information

Certain statements contained in this quarterly report are not historical facts, including but not limited to statements that can be identified by the use of forward-looking terminology such as “may”, “will”, “expect”, “anticipate”, or “continue” or the negative thereof or other variations thereon or comparable terminology are “forward-looking statements” within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21B of the Securities Act of 1934, as amended. Actual results could differ materially from those indicated in such statements due to risks, uncertainties and changes with respect to a variety of market and other factors. The Company assumes no obligation to update any forward-looking statements.

General - First Defiance is a unitary thrift holding company that conducts business through its two wholly owned subsidiaries, First Federal and First Insurance. First Federal is a federally chartered savings bank that provides financial services through 33 full service banking centers in communities based in northwest Ohio, northeast Indiana, and southeastern Michigan. On June 21, 2012, First Federal opened a new full service banking center in Bowling Green, Ohio, making it the second full service banking center in Bowling Green. On August 31, 2012, First Federal closed its banking center in Tecumseh East, Michigan. Due to its proximity with Tecumseh West, less than three miles, management decided to close the drive-up facility in Tecumseh East and merge it into Tecumseh West. 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’s offices in Defiance, Archbold, Bryan, Bowling Green, Maumee and Oregon, Ohio.

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 exists for a balance between acquisition and organic growth. The primary segments of First Defiance’s business strategy are 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. In 2012, management intends to continue to focus on asset quality, core deposit growth, expense control as well as other opportunities to further service our customers.

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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 complement the needs 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 deposit, 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 focused 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. 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 financial institution acquisition being 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.

Investments - First Defiance invests in U.S. Treasury and federal government agency obligations, obligations of municipal and other political subdivisions, mortgage-backed securities which are issued by federal agencies, corporate bonds, and collateralized mortgage obligations ("CMOs") and real estate mortgage investment conduits ("REMICs"). Management determines the appropriate classification of all such securities at the time of purchase in accordance with FASB ASC Topic 320.

Securities are classified as held-to-maturity when First Defiance has the positive intent and ability to hold the security to maturity. Held-to-maturity securities are stated at amortized cost and had a recorded value of $585,000 at September 30, 2012. Securities not classified as held-to-maturity are classified as available-for-sale, which are stated at fair value and had a recorded value of $269.1 million at September 30, 2012. The available-for-sale portfolio consists of obligations of U.S. Government corporations and agencies ($21.6 million), certain municipal obligations ($84.7 million), CMOs ($65.0 million), corporate bonds ($8.8 million), mortgage backed securities ($85.5 million), U.S. treasury bonds ($2.0 million) and trust preferred and preferred stock ($1.4 million).

In accordance with 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 the impairment related to other factors is recognized in other comprehensive income.

Lending - 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 TDR loans are classified as non-performing loans. Non-performing status automatically occurs in the month in which the 90 day delinquency occurs. For TDR 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. TDR 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.

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 a TDR 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 TDR 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 TDRs, 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 TDRs are not expected to be deemed collateral dependent. If the TDR is deemed collateral dependent, then reserves are calculated based on the fair value of the collateral. The difference between the carrying value and fair value of the loan is recorded as a valuation allowance.

Earnings - The profitability of First Defiance is primarily dependent on its net interest income and non-interest income. Net interest income is the difference between interest income on interest-earning assets, principally loans and securities, and interest expense on interest-bearing deposits, FHLB advances, and other borrowings. The Company’s non-interest income is mainly derived from service fees and other charges, mortgage banking income, and insurance commissions. First Defiance's earnings also depend on the provision for loan losses and non-interest expenses, such as employee compensation and benefits, occupancy and equipment expense, deposit insurance premiums, and miscellaneous other expenses, as well as federal income tax expense.

Participation in the U.S. Treasury Capital Purchase Program

On December 5, 2008, as part of the 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 qualified as Tier 1 capital and paid cumulative dividends at a rate of 5% per annum for the first five years, and 9% per annum thereafter. The Senior Preferred Shares were not subject to any contractual restrictions on transfer, except that the U.S. Treasury or any of its transferees could 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.

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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 was 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 was restricted. These restrictions terminated on the third anniversary of the date of issuance of the Senior Preferred Shares except that, after the third anniversary of the date of issuance of the Senior Preferred Shares, the Company could not increase its common dividends per share without obtaining consent of the U.S. Treasury.

The Purchase Agreement also subjected 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.

In June 2012, the U.S. Treasury sold its preferred stock of the Company through a public offering structured as a modified Dutch auction. The Company bid on its preferred stock in the auction after receiving approval from its regulators. The clearing price per share for the preferred shares was $962.66 (compared to a par value of $1,000.00 per share) and the Company was successful in repurchasing 16,560 of the 37,000 preferred shares outstanding through the auction process. The Company also successfully acquired an additional 19,440 preferred shares in the secondary market prior to the end of the second quarter. The clearing prices per share for the preferred shares purchased in the secondary market were as follows: 1,100 shares at $997.50, 1,500 shares at $1,000.00 and 16,840 shares at $998.75.

On July 18, 2012, the Company purchased the remaining 1,000 preferred shares at par value to complete the entire repurchase of the 37,000 preferred shares.

The net balance sheet impact of the repurchase was a reduction to stockholders' equity of $36.4 million which is comprised of a decrease in preferred stock of $37.0 million and a $642,000 increase to retained earnings related to the discount on the shares repurchased, which is also included in net income applicable to common shares for purposes of calculating earnings per share.

Included in the 2012 operating results is $181,000 of costs incurred by the Company related to the U.S. Treasury's offering. All these costs were incurred in the second quarter of 2012. These costs are not tax-deductible.

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Balance Sheet Restructure

In October 2012, the Company executed a balance sheet restructuring strategy to enhance the Company's current and future profitability while increasing its capital ratios and protecting the balance sheet from rising rates. The strategy required taking an after tax loss of approximately $260,000 by selling $60 million in securities for a gain of $1.6 million and paying off $62 million in FHLB advances with a prepayment penalty of $2.0 million. The ongoing positive effects of this strategy: 1) increases the net interest margin and net interest income, 2) improves all capital ratios and 3) increases return on average assets and return on average equity.

Changes in Financial Condition

At September 30, 2012, First Defiance's total assets, deposits and stockholders' equity amounted to $2.06 billion, $1.61 billion and $255.1 million, respectively, compared to $2.07 billion, $1.60 billion and $278.1 million, respectively, at December 31, 2011.

Net loans receivable (excluding loans held for sale) increased $32.0 million to $1.49 billion. The variances in loans receivable between September 30, 2012 and December 31, 2011 include increases in commercial loans (up $16.5 million), commercial real estate loans (up $16.4 million) and one to four family residential real estate loans (up $6.7 million), partially offset by decreases in home equity and improvement loans (down $10.6 million), consumer loans (down $2.1 million) and construction loans (down $0.1 million).

The investment securities portfolio increased $36.1 million to $269.7 million at September 30, 2012 from $233.6 million at December 31, 2011. The increase is the result of $91.5 million of securities being purchased during the first nine months of 2012, offset by $19.8 million of securities maturing or being called in the period, principal pay downs of $29.8 million in CMOs and mortgage-backed securities, and $8.0 million of securities being sold. There was an unrealized gain in the investment portfolio of $10.1 million at September 30, 2012 compared to an unrealized gain of $7.2 million at December 31, 2011.

Deposits increased from $1.60 billion at December 31, 2011 to $1.61 billion as of September 30, 2012. Of the $13.1 million increase, interest-bearing demand deposits and money market accounts increased $27.5 million to $636.5 million, savings accounts increased $11.1 million to $166.2 million and non-interest-bearing demand deposits increased $25.4 million to $271.3 million. These increases were somewhat offset by a decline in retail time deposits of $42.4 million to $533.1 million and broker/national certificates of deposit decreasing by $8.4 million to $2.3 million.

Stockholders' equity decreased from $278.1 million at December 31, 2011 to $255.1 million at September 30, 2012. The decreases in stockholders' equity were the result of recording $1.5 million of common stock dividends being paid and $900,000 of accrued dividends on preferred stock, and $36.4 million being paid to redeem the outstanding preferred shares as described above in the Participation in the U.S. Treasury Capital Purchase Program section. The decreases were partially offset by net income of $13.5 million.

Average Balances, Net Interest Income and Yields Earned and Rates Paid

The following table presents for the periods indicated the total dollar amount of interest from average interest-earning assets and the resultant yields, as well as the interest expense on average interest-bearing liabilities, expressed both in thousands of dollars and rates, and the net interest margin. The table reports interest income from tax-exempt loans and investment on a tax-equivalent basis. All average balances are based upon daily balances (dollars in thousands).

	Three Months Ended September 30,					
	2012			2011		
	Average Balance	Interest(1)	Yield/ Rate(2)	Average Balance	Interest(1)	Yield/ Rate(2)
Interest-earning assets:						
Loans receivable	$1,481,995	$ 18,024	4.84 %	$1,419,987	$ 19,519	5.45 %
Securities	274,327	2,245	3.37	220,040	2,220	4.10
Interest bearing deposits	72,738	43	0.24	183,199	110	0.24
FHLB stock	20,655	213	4.10	20,655	203	3.90
Total interest-earning assets	1,849,715	20,525	4.44	1,843,881	22,052	4.76
Non-interest-earning assets	197,424			212,230		
Total assets	$2,047,139			$2,056,111		
Interest-bearing liabilities:						
Deposits	$1,339,333	$ 1,909	0.57 %	$1,353,009	$ 2,791	0.82 %
FHLB advances	81,812	759	3.69	88,146	768	3.46
Notes payable	50,610	83	0.65	55,149	127	0.91
Subordinated debentures	36,141	172	1.89	36,195	333	3.65
Total interest-bearing liabilities	1,507,896	2,923	0.77	1,532,499	4,019	1.04
Non-interest bearing deposits	266,416	-		230,164	-	
Total including non-interest bearing demand deposits	1,774,312	2,923	0.66	1,762,663	4,019	0.90
Other non-interest-bearing liabilities	21,235			21,712		
Total liabilities	1,795,547			1,784,375		
Stockholders' equity	251,592			271,736		
Total liabilities and stockholders' equity	$2,047,139			$2,056,111		
Net interest income; interest rate spread		$ 17,602	3.67 %		$ 18,033	3.72 %
Net interest margin (3)			3.80 %			3.89 %
Average interest-earning assets to average interest-bearing liabilities			123 %			120 %

(1)

Interest on certain tax-exempt loans and securities is not taxable for Federal income tax purposes. 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) Annualized

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

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	Nine Months Ended September 30,								
	2012				2011				
	Average Balance	Interest(1)	Yield/ Rate(2)		Average Balance	Interest(1)	Yield/ Rate(2)		
Interest-earning assets:									
Loans receivable	$1,467,038	$ 54,925	5.00	%	$1,436,505	$ 59,650	5.57	%	
Securities	261,628	6,775	3.58		195,640	6,218	4.33		
Interest bearing deposits	128,711	249	0.26		190,776	351	0.25		
FHLB stock	20,655	656	4.24		20,890	662	4.25		
Total interest-earning assets	1,878,032	62,605	4.45		1,843,811	66,881	4.86		
Non-interest-earning assets	198,740				211,388				
Total assets	$2,076,772				$2,055,199				
Interest-bearing liabilities:									
Deposits	$1,357,499	$ 6,394	0.63	%	$1,362,239	$ 9,648	0.95	%	
FHLB advances	81,823	2,260	3.69		97,610	2,442	3.35		
Notes payable	52,312	284	0.73		55,341	397	0.96		
Subordinated debentures	36,179	813	3.00		36,219	945	3.50		
Total interest-bearing liabilities	1,527,813	9,751	0.85		1,551,409	13,432	1.16		
Non-interest bearing deposits	257,540	-			226,287	-			
Total including non-interest bearing demand deposits	1,785,353	9,751	0.73		1,777,696	13,432	1.01		
Other non-interest-bearing liabilities	20,595				17,568				
Total liabilities	1,805,948				1,795,264				
Stockholders' equity	270,824				259,935				
Total liabilities and stockholders' equity	$2,076,772				$2,055,199				
Net interest income; interest rate spread		$ 52,854	3.60	%		$ 53,449	3.70	%	
Net interest margin (3)			3.78	%			3.89	%	
Average interest-earning assets to average interest-bearing liabilities			123	%			118	%	

(1) Interest on certain tax-exempt loans and securities is not taxable for Federal income tax purposes. 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) Annualized

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

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Results of Operations

Three Months Ended September 30, 2012 and 2011

On a consolidated basis, First Defiance's net income for the quarter ended September 30, 2012 was $5.4 million compared to net income of $4.1 million for the comparable period in 2011. Net income applicable to common shares was $5.4 million for the third quarter of 2012 compared to $3.6 million for the comparable period in 2011. On a per share basis, basic and diluted earnings per common share for the three months ended September 30, 2012 were $0.56 and $0.54, respectively, compared to basic and diluted earnings per common share of $0.37 and $0.36, respectively, for the quarter ended September 30, 2011.

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 and into 2012, the Company accelerated its strategy to increase investment security purchases by selectively deploying lower yielding overnight deposits into investment securities on the short to intermediate end of the yield curve. This will continue throughout 2012 as management deems it appropriate within its liquidity strategy and until management sees evidence of sustainable net loan growth.

Net interest income was $17.2 million for the quarter ended September 30, 2012, a decrease from $17.6 million for the same period in 2011. The tax-equivalent net interest margin was 3.80% for the quarter ended September 30, 2012 compared to 3.89% for the same period in 2011. The decrease in margin between the 2011 and 2012 third quarters is mainly due to a decline in the interest rate spread, which decreased to 3.67% in the third quarter of 2012 from 3.72% for the same period in 2011. The decrease in spread occurred due to interest-earning asset yields decreasing by 32 basis points (to 4.44% in the third quarter of 2012 from 4.76% for the same period in 2011), which was partially offset by the cost of interest-bearing liabilities between the two periods decreasing 27 basis points (to 0.77% in the third quarter of 2012 from 1.04% in the same period in 2011).

Total interest income decreased by $1.6 million or 7.2% to $20.1 million for the quarter ended September 30, 2012 from $21.7 million for the same period in 2011. 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 61 basis points to 4.84% at September 30,

2012. Interest income from loans decreased to $18.0 million for the quarter ended September 30, 2012 compared to $19.5 million for the same period in 2011, which represents a decline of 7.6%.

Interest expense decreased by $1.1 million in the third quarter of 2012 compared to the same period in 2011, to $2.9 million from $4.0 million. This decrease was due to a 27 basis point decline in the average cost of interest-bearing liabilities in the third quarter of 2012. Interest expense related to interest-bearing deposits was $1.9 million in the third quarter of 2012 compared to $2.8 million for the same period in 2011. Interest expense recognized by the Company related to subordinated debentures was $172,000 in the third quarter of 2012 compared to $333,000 for the same period in 2011. Expenses on FHLB advances and securities sold under repurchase agreements were $759,000 and $83,000 respectively in the third quarter of 2012 compared to $768,000 and $127,000 respectively for the same period in 2011.

Provision 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 $1 million 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.

For purposes 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 rolling eight quarters ending September 30, 2012.

The stratification of the loan portfolio resulted in a quantitative general allowance of $18.0 million at September 30, 2012 compared to $19.5 million at December 31, 2011.

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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 September 30, 2012 indicated a general reserve of $7.6 million compared with $6.5 million at December 31, 2011. The increase was due to several qualitative factors adjusted in the third quarter of 2012. The environmental factors were increased for consumer loans due to the continued stress on the unsecured portion of home equity loans and the higher quantitative trend. The reason for the increase in home equity is also based on a higher quantitative trend as well as added stress on second mortgages in this environment. A positive for the third quarter of 2012 was that thirteen of the fourteen counties in the Company’s footprint were at or below the national unemployment average of 7.6% as of September 30, 2012. The unemployment rates in August 2012 ranged from a low of 5.2% to a high of 8.8% compared to the unemployment rates in December 2011 ranging from a low of 7.4% to a high of 13.3%. August was the last month available for unemployment rates when preparing this report, except for Allen County, Indiana where September was available.

As a result of the quantitative and qualitative analyses, along with the change in specific reserves, the Company’s provision for loan losses for the third quarter of 2012 was $705,000, compared to $3.1 million for the same period in 2011. The allowance for loan losses was $26.3 million and $33.3 million and represented 1.74% and 2.24% of loans, net of undisbursed loan funds and deferred fees and costs, as of September 30, 2012 and December 31, 2011, respectively. The provision of $705,000 was offset by charge offs of $1.6 million and recoveries of $770,000 resulting in a slight decrease to the overall allowance for loan loss at September 30, 2012. The stability in the level of the allowance for loan loss is supported by the overall improvement in asset quality evidenced by the continued decline in loan delinquencies and classified loans. Total charge-offs declined sharply from the first and second quarters of 2012 when established specific reserves were charged off and further updated collateral values on collateral dependent loans resulted in a high level of charge offs. In management’s opinion, the overall allowance for loan losses of $26.3 million as of September 30, 2012 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 the third quarter of 2012, First Defiance recorded OREO write-downs that totaled $36,000 compared to write-downs of $93,000 for the same period in 2011. These write-downs are primarily due to decreasing the liquidation values in order to spur interest in our market areas to sell these properties. These amounts are included in other non-interest expense. Management believes that the values recorded at September 30, 2012 for real estate owned and repossessed assets represent the realizable value of such assets.

Total classified loans decreased to $90.3 million at September 30, 2012, compared to $122.5 million at December 31, 2011. First Federal also has classified $0 of loans doubtful at September 30, 2012, compared to $10,000 at December 31, 2011.

First Federal's ratio of allowance for loan losses to non-performing loans was 62.5% at September 30, 2012 compared with 77.9% at December 31, 2011. Management monitors collateral values of all loans included on the watch list that are collateral dependent and believes that allowances for those loans at September 30, 2012 are appropriate. The Company did experience a decrease in non-accrual loans in the third quarter of 2012. Of the total non-accrual loans, $23.4 million or 62.0% are 90 days or less past due and paying in accordance with the terms of the note.

At September 30, 2012, First Defiance had total non-performing assets of $45.0 million, compared to $46.3 million at December 31, 2011. 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 September 30, 2012 and December 31, 2011 by category were as follows:

Table 1 – Non-Performing Asset

	September 30, 2012	December 31, 2011
	(In thousands)	
Non-performing loans:		
Single-family residential	$5,784	$ 3,890
Construction	-	-
Non-residential and multi-family residential real estate	24,991	28,150
Commercial	6,670	6,884
Consumer finance	15	10
Home equity and improvement	343	394
Troubled debt restructured loans, accruing	4,305	3,380
Total non-performing loans	42,108	42,708
Real estate owned and repossessed assets	2,843	3,628
Total non-performing assets	$44,951	$ 46,336
Allowance for loan losses as a percentage of total loans*	1.74 %	2.24 %
Allowance for loan losses as a percentage of non-performing assets	58.53 %	71.77 %
Allowance for loan losses as a percentage of non-performing loans	62.48 %	77.86 %
Total non-performing assets as a percentage of total assets	2.19 %	2.24 %
Total non-performing loans as a percentage of total loans*	2.78 %	2.87 %

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

The largest category in non-performing loans is commercial real estate loans. The balance of this type of non-performing loan was $3.2 million lower at September 30, 2012 compared to December 31, 2011.

Non-performing loans in the commercial real estate category represented 3.15% of the total loans in those categories at September 30, 2012 compared to 3.63% for the same category at December 31, 2011. Management believes that the current allowance for loan losses is appropriate and that the provision for loan losses recorded in the third quarter of 2012 is consistent with both charge-off experience and the risk inherent in the overall credits in the portfolio.

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).

The following table details net charge-offs and nonaccrual loans by loan type. For the nine months ended and as of September 30, 2012, commercial real estate, which represented 51.87% of total loans, accounted for 65.76% of net charge-offs and 66.11% of nonaccrual loans, and commercial loans, which represented 23.93% of total loans, accounted for 21.06% of net charge-offs and 17.64% of nonaccrual loans. For the nine months ended and as of September 30, 2011, commercial real estate, which represented 51.96% of total loans, accounted for 44.17% of net charge-offs and 73.02% of nonaccrual loans, and commercial loans, which represented 22.99% of total loans, accounted for 39.71% of net charge-offs and 17.56% of nonaccrual loans.

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

	For the Nine Months Ended September 30, 2012		As of September 30, 2012	
	Net Charge-offs (in thousands)	% of Total Net Charge-offs	Nonaccrual Loans (in thousands)	% of Total Non-Accrual Loans
Residential	$ 1,389	9.11 %	$ 5,784	15.30 %
Construction	-	0.00 %	-	0.00 %
Commercial real estate	10,029	65.76 %	24,991	66.11 %
Commercial	3,212	21.06 %	6,670	17.64 %
Consumer	29	0.19 %	15	0.04 %
Home equity and improvement	591	3.88 %	343	0.91 %
Total	$ 15,250	100.00 %	$ 37,803	100.00 %

	For the Nine Months Ended September 30, 2011		As of September 30, 2011	
	Net Charge-offs (in thousands)	% of Total Net Charge-offs	Nonaccrual Loans (in thousands)	% of Total Non-Accrual Loans
Residential	$ 609	11.04 %	$ 4,017	8.32 %
Construction	-	0.00 %	60	0.12 %
Commercial real estate	2,437	44.17 %	35,268	73.02 %
Commercial	2,191	39.71 %	8,478	17.56 %
Consumer	25	0.46 %	20	0.04 %
Home equity and improvement	255	4.62 %	454	0.94 %
Total	$ 5,517	100.00 %	$ 48,297	100.00 %

Table 3 – Allowance for Loan Loss Activity

	For the Quarter Ended				
	3rd 2012	2nd 2012	1st 2012	4th 2011	3rd 2011
	(Dollars in Thousands)				
Allowance at beginning of period	$26,409	$ 28,833	$ 33,254	$ 38,110	$ 40,530
Provision for credit losses	705	4,097	3,503	4,099	3,097
Charge-offs:					
Residential	217	584	738	666	647
Commercial real estate	780	5,448	4,496	6,737	2,622
Commercial	355	486	2,666	1,423	2,533
Consumer finance	19	14	41	28	36
Home equity and improvement	203	254	211	251	290
Total charge-offs	1,574	6,786	8,152	9,105	6,128

Recoveries	770	265	228	150	611
Net charge-offs	804	6,521	7,924	8,955	5,517
Ending allowance	$26,310	$26,409	$28,833	$33,254	$38,110

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

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Table 4 – Allowance for Loan Loss Allocation by Loan Category

	September 30, 2012		June 30, 2012		March 31, 2012		December 31, 2011		September 30, 2011	
	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
Residential	$2,996	13.75 %	$3,104	13.94 %	$3,373	13.58 %	$4,095	13.55 %	$4.023	12.86 %
Construction	63	2.06 %	48	1.52 %	73	2.44 %	4 63	2.10 %	69	2.39 %
Commercial real estate	16,260	51.87 %	16,562	51.33 %	19,031	53.10 %	20,490	51.70 %	24,523	51.96 %
Commercial	5,103	23.92 %	5,087	24.64 %	4,693	21.97 %	6 6,576	23.25 %	7,804	22.99 %
Consumer	147	1.10 %	140	1.13 %	178	1.19 %	174	1.26 %	219	1.34 %
Home equity and improvement	1,741	7.30 %	1,468	7.44 %	1,485	7.72 %	1,856	8.14 %	1,472	8.47 %
	$26,310	100.00 %	$26,409	100.00 %	$28,833	100.00 %	$33,254	100.00 %	$38,110	100.00 %

Key Asset Quality Ratio Trends

Table 5 – Key Asset Quality Ratio Trends

	3rd Qtr 2012	2nd Qtr 2012	1st Qtr 2012	4th Qtr 2011	3rd Qtr 2011
Allowance for loan losses / loans*	1.74 %	1.76 %	1.96 %	2.24 %	2.61 %
Allowance for loan losses to net charge-offs	3,272.39 %	404.98 %	363.87 %	371.35 %	690.77 %
Allowance for loan losses / non-performing assets	58.53 %	54.09 %	54.84 %	71.77 %	66.82 %
Allowance for loan losses / non-performing loans	62.48 %	58.32 %	58.64 %	77.86 %	74.39 %
Non-performing assets / loans plus REO*	2.97 %	3.25 %	3.56 %	3.11 %	3.89 %
Non-performing assets / total assets	2.19 %	2.36 %	2.45 %	2.24 %	2.77 %
Net charge-offs / average loans (annualized)	0.22 %	1.78 %	2.18 %	2.49 %	1.55 %

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

Non-Interest Income.

Total non-interest income increased $923,000 in the third quarter of 2012 to $7.8 million from $6.9 million for the same period in 2011.

Service Fees. Service fees and other charges decreased by $281,000 or 9.2% in the third quarter of 2012 compared to the same period in 2011.

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 quarters ending September 30, 2012 and 2011 related to the overdraft privilege product, net of adjustments to the allowance for uncollectible overdrafts, were $1.1 million and $1.5 million, respectively. Accounts charged off are included in noninterest expense. The allowance for uncollectible overdrafts was $11,000 at September 30, 2012, $67,000 at December 31, 2011 and $60,000 at September 30, 2011.

Mortgage Banking Activity. Total revenue from the sale and servicing of mortgage loans increased $865,000 to $2.2 million for the third quarter of 2012 compared to $1.4 million for the same period of 2011. This increase was primarily due to higher loan origination volume for the quarter, the result of higher refinancing activity due to lower interest rates on conforming saleable mortgage-based products in the third quarter of 2012 compared to the same period in 2011. Gains realized from the sale of mortgage loans increased in the third quarter of 2012 to $2.9 million from $2.1 million in the same period of 2011. The amortization of mortgage servicing rights expense increased $339,000 to $892,000 in the third quarter of 2012 compared to $553,000 in the same period in 2011. The Company recorded a negative valuation adjustment of $600,000 on mortgage servicing rights in the third quarter of 2012 compared to a negative valuation adjustment of $1.1 million for the same period of 2011. The negative valuation adjustments in the third quarter of 2012 and 2011 were driven by a decline in the fair values of certain sectors of the Company's portfolio of mortgage servicing rights.

Insurance and Investment Sales Commissions. Income from the sale of insurance and investment products decreased $90,000 in the third quarter of 2012 to $2.0 million, relatively flat with the same period of 2011.

Impairment of Securities. First Defiance did not have any other-than-temporary impairment ("OTTI") charges in the third quarter of 2012 and for the same period in 2011 reflecting a more stable environment relating to its Trust Preferred Collateralized Debt Obligation ("CDO") investments. In June 2012, the Company was notified that its Preferred Term Security VI was redeemed through an auction process. The security was redeemed at full price with proceeds being received in July 2012. This security had previously identified OTTI of $80,000. The previous OTTI amount was recorded as a yield adjustment in interest income in June 2012.

Other non-interest income. Other non-interest income increased $350,000 to $316,000 in the third quarter of 2012 from a loss of $34,000 for the same period in 2011. This increase is mainly attributable to the increase in the value of the assets of the deferred compensation plan of $75,000 in the third quarter of 2012 compared to a decrease of those assets of $285,000 for the same period in 2011.

Non-Interest Expense.

Non-interest expense increased to $16.5 million for the third quarter of 2012 compared to $15.5 million for the same period in 2011.

Occupancy Expenses. Occupancy expenses increased by $391,000 to $2.2 million for the quarter ended September 30, 2012 from $1.8 million for the same period in 2011. The increase is mainly attributable to an increase in deferred rent liabilities of approximately $366,000 in the third quarter of 2012.

Other Non-Interest Expenses. Other non-interest expenses increased by $504,000 to $3.2 million for the quarter ended September 30, 2012 from $2.7 million for the same period in 2011. The main driver behind the increase between the 2012 and 2011 third quarters is a $107,000 increase in the value of the liabilities of the deferred compensation plan for the third quarter of 2012 compared to a decrease in those liabilities of $283,000 for the same period in 2011.

The efficiency ratio, considering tax equivalent interest income and excluding securities gains and losses, for the third quarter of 2012 was 65.07% compared to 62.12% for the same period in 2011.

Income Taxes.

First Defiance computes federal income tax expense in accordance with ASC Topic 740, Subtopic 942, which resulted in an effective tax rate of 30.3% for the quarter ended September 30, 2012 compared to 31.7% for the same period in 2011. 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.

Nine Months Ended September 30, 2012 and 2011

On a consolidated basis, First Defiance's net income for the nine months ended September 30, 2012 was $13.5 million compared to income of $11.5 million for the comparable period in 2011. Net income applicable to common shares was $12.9 million for the nine months ended September 30, 2012 compared to $10.0 million for the comparable period in 2011. On a per share basis, basic and diluted earnings per common share for the nine months ended September 30, 2012 were $1.33 and $1.29, respectively, compared to basic and diluted earnings per common share of

$1.08 and $1.06, respectively, for the comparable period in 2011.

Net Interest Income.

Net interest income was $51.6 million for the nine months ended September 30, 2012 compared to $52.4 million for the same period in 2011. For the nine month period ended September 30, 2012, total interest income was $61.4 million, a $4.4 million decrease from the same period in 2011. Despite average earning assets increasing $34.2 million in the first nine months of 2012, the average yield declined 41 basis points as a result of a lower rate environment.

Interest expense decreased by $3.6 million to $9.8 million for the nine months ended September 30, 2012 compared to $13.4 million for the same period in 2011. Average cost of interest-bearing liabilities for the nine months ending September 30, 2012 declined to 0.85%, a 31 basis point decrease from the 1.16% average cost in the first nine months of 2011 is the result of the continued low rate environment which has given management opportunities to re-price on the liability side.

Provision for Loan Losses.

The provision for loan losses was $8.3 million for the nine months ended September 30, 2012, compared to $8.3 million during the nine months ended September 30, 2011. Charge-offs for the first nine months of 2012 were $16.5 million and recoveries of previously charged off loans totaled $1.3 million for net charge-offs of $15.2 million. By comparison, $12.3 million of charge-offs were recorded in the same period of 2011 and $1.0 million of recoveries were realized for net charge-offs of $11.3 million.

Non-Interest Income.

Total non-interest income increased to $24.2 million for the nine months ended September 30, 2012 from $19.6 million recognized in the same period of 2011.

Mortgage Banking Activity. Total revenue from the sale and servicing of mortgage loans increased 52.2% to $6.9 million for the nine months ended September 30, 2012 from $4.5 million for the same period of 2011. Gains realized from the sale of mortgage loans increased $3.9 million to $7.9 million for the first nine months of 2012 from $4.0 million during the same period of 2011. Mortgage loan servicing revenue remained flat at $2.5 million in the first nine months of 2012 compared to the same period of 2011. The increase in gains were partially offset by an expense increase of $1.3 million for the amortization of mortgage servicing rights in the first nine months of 2012 when compared to 2011. The Company recorded a negative valuation adjustment of $855,000 in the first nine months of 2012 compared to a negative adjustment of $585,000 in the first nine months of 2011.

Insurance and Investment Sales Commission. Insurance and investment sales commission income increased $1.6 million, to $6.7 million for the nine months ended September 30, 2012, from $5.1 million during the same period in 2011. This is the result of receiving more contingent commission income in the first nine months of 2012 compared to the same period of 2011. In 2012, $508,000 was received compared to $329,000 in 2011. The insurance agency acquired from PDI in July 2011 added approximately $1.9 million in revenue in the first nine months of 2012 compared to $583,000 for the same period in 2011.

Impairment on Securities. First Defiance did not have any OTTI charges in the first nine months of 2012 reflecting a more stable environment relating to its CDO investments. In the first nine months of 2011, First Defiance recognized OTTI charges of $2,200 for one impaired investment security, where in management's opinion, the value of the investment will not be fully recovered. The OTTI charge related to one CDO investment with a remaining book value of $902,000.

Non-Interest Expense.

Non-interest expense increased to $48.2 million for the first nine months of 2012 compared to $47.2 million for the same period in 2011.

Compensation and Benefits. Compensation and benefits increased to $24.8 million for the nine months ended September 30, 2012 from $23.5 million for the same period in 2011. The increase is mainly attributable to the July 2011 insurance acquisition that added approximately $1.2 million in compensation and benefits expense in the first nine months of 2012 compared to $415,000 for the same period in 2011. Also, the Company experienced an increase in commission expense as a result of the increased insurance activity.

FDIC Insurance Premiums. FDIC expense decreased to $2.0 million in the first nine months of 2012, from $2.3 million in the same period in 2011. This decrease was the result of the change in the rate assessment calculation in September 2011 affected by the Dodd-Frank legislation.

Other Non-Interest Expenses. Other non-interest expenses (including state franchise tax, data processing, amortization of intangibles and other) decreased by $64,000 to $15.7 million for the first nine months of 2012 from $15.8 million for the same period in 2011. Year-over-year decreases between 2012 and 2011 include a reduction in secondary market buy-back losses of $201,000 as a result of underwriting issues identified in the first nine months of 2011 after the loans had been sold and a $766,000 reduction in other credit related costs which includes credit, collection and other real estate owned expenses. The year-over-year decreases are mainly offset by increases in data processing expenses in 2012 as a result of implementation of various projects throughout the year.

The efficiency ratio for the first nine months of 2012 was 63.04% compared to 64.59% for the same period of 2011.

Liquidity

As a regulated financial institution, First Federal is required to maintain appropriate levels of “liquid” assets to meet short-term funding requirements.

First Defiance had $33.6 million of cash provided by operating activities during the first nine months of 2012. The Company’s cash used in operating activities resulted from the origination of loans held for sale mostly offset by the proceeds on the sale of loans.

At September 30, 2012, First Federal had $81.4 million in outstanding loan commitments and loans in process to be funded generally within the next six months and an additional $292.0 million committed under existing consumer and commercial lines of credit and standby letters of credit. Also at that date, First Federal had commitments to sell $63.1 million of loans held-for-sale. First Defiance believes that it has adequate resources to fund commitments as they arise and that it can adjust the rate on savings certificates to retain deposits in changing interest rate environments. If First Defiance requires funds beyond its internal funding capabilities, advances from the FHLB of Cincinnati and other financial institutions are available.

Liquidity risk arises from the possibility that the Company may not be able to meet its financial obligations and operating cash needs or may become overly reliant upon external funding sources. In order to manage this risk, the Company's Board of Directors has established a Liquidity Policy that identifies primary sources of liquidity, establishes procedures for monitoring and measuring liquidity and quantifies minimum liquidity requirements. This policy designates First Federal's Asset/Liability Committee ("ALCO") as the body responsible for meeting these objectives. The ALCO reviews liquidity on a monthly basis and approves significant changes in strategies that affect balance sheet or cash flow positions. Liquidity is centrally managed on a daily basis by the Company's Chief Financial Officer and Controller.

The ALCO uses an economic value of equity ("EVE") analysis to measure risk in the balance sheet incorporating all cash flows over the estimated remaining life of all balance sheet positions. The EVE 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 rates as of September 30, 2012 was considered to be remote given the current interest rate environment and therefore, was not included in this analysis. The results of this analysis are reflected in the following tables for the nine months ended September 30, 2012 and the year-ended December 31, 2011.

September 30, 2012
Economic Value of Equity

Change in Rates	$ Amount	$ Change	% Change	
	(Dollars in Thousands)			
+400 bp	428,384	60,172	16.34	%
+ 300 bp	419,141	50,929	13.83	%
+ 200 bp	406,817	38,605	10.48	%
+ 100 bp	391,263	23,051	6.26	%
0 bp	368,212	–	–	

December 31, 2011
Economic Value of Equity

Change in Rates	$ Amount	$ Change	% Change	
	(Dollars in Thousands)			
+400 bp	471,564	64,772	15.92	%
+ 300 bp	460,756	53,964	13.27	%
+ 200 bp	447,035	40,243	9.89	%
+ 100 bp	430,361	23,570	5.79	%
0 bp	406,792	–	–	

Capital Resources

Capital is managed at First Federal and on a consolidated basis. Capital levels are maintained based on regulatory capital requirements and the economic capital required to support credit, market, liquidity and operational risks inherent in our business, as well as flexibility needed for future growth and new business opportunities.

Capital Purchase Plan Capital

During 2008, First Defiance received $37.0 million of equity capital by issuing 37,000 shares of Preferred Stock to the U.S. Department of Treasury, and a ten-year warrant to purchase up to 550,595 shares of First Defiance’s common stock, par value $0.01 per share, at an exercise price of $10.08 per share. The proceeds received were allocated to the preferred stock and additional paid-in-capital.

In June 2012, the U.S. Treasury sold its preferred stock of the Company through a public offering structured as a modified Dutch auction. The Company bid on its preferred stock in the auction after receiving approval from its regulators. The clearing price per share for the preferred shares was $962.66 (compared to a par value of $1,000.00 per share) and the Company was successful in repurchasing 16,560 of the 37,000 preferred shares outstanding through the auction process. Included in the second quarter of 2012 operating results was $181,000 of costs incurred by the Company related to the offering. These costs were not tax-deductible. The Company had also successfully acquired an additional 19,440 preferred shares in the secondary market prior to the end of the second quarter. The net balance sheet impact was a reduction to stockholders' equity of $35.4 million which is comprised of a decrease in preferred stock of $36.0 million and a $642,000 increase to retained earnings related to the discount on the shares repurchased. In July, the Company acquired the remaining 1,000 preferred shares to complete the entire repurchase of the 37,000 preferred shares.

Capital Adequacy

First Federal is required to maintain specified amounts of capital pursuant to regulations promulgated by the Office of the Comptroller of the Currency. The capital standards generally require the maintenance of regulatory capital sufficient to meet a tangible capital requirement, a core capital requirement, and a risk-based capital requirement. The following table sets forth First Federal's compliance with each of the capital requirements at September 30, 2012 (in thousands).

	Actual		Minimum Required for Adequately Capitalized		Minimum Required for Well Capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
Tier 1 Capital (1)						
Consolidated	$221,922	11.20%	$ 79,285	4.0 %	$ 99,106	5.0 %
First Federal Bank	$209,917	10.61%	$ 79,136	4.0 %	$ 98,820	5.0 %
Total Capital (to Risk Weighted Assets) (1)						
Consolidated	$242,993	14.46%	$ 134,438	8.0 %	$ 168,048	10.0 %
First Federal Bank	$230,965	13.76%	$ 134,287	8.0 %	$ 167,859	10.0 %

(1) Core capital is computed as a percentage of adjusted total assets of $1.98 billion and $1.98 billion for consolidated and the bank, respectively. Risk-based capital is computed as a percentage of total risk-weighted assets of $1.68 billion and $1.68 billion for consolidated and the bank, respectively.

Critical Accounting Policies

First Defiance has established various accounting policies which 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 included in the Company's Annual Report on Form 10-K. 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. Those policies which are identified and discussed in detail in the Company's Annual Report on Form 10-K include the Allowance for Loan Losses, Valuation of Securities, and the Valuation of Mortgage Servicing Rights. There have been no material changes in assumptions or judgments relative to those critical policies during the first nine months of 2012.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

As discussed in detail in the 2011 Annual Report on Form 10-K, First Defiance’s ability to maximize net income is dependent on management’s ability to plan and control net interest income through management of the pricing and mix of assets and liabilities. Because a large portion of assets and liabilities of First Defiance are monetary in nature, changes in interest rates and monetary or fiscal policy affect its financial condition and can have significant impact on the net income of the Company. First Defiance does not use off-balance sheet derivatives to enhance its risk management, nor does it engage in trading activities beyond the sale of mortgage loans.

First Defiance monitors its exposure to 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, using September 30, 2012 amounts as a base case, First Defiance’s net interest income would be impacted by less than the board mandated guidelines of 10%.

Item 4. Controls and Procedures

Disclosure controls are procedures designed to ensure that information required to be disclosed in the Company's reports filed under the Exchange Act, such as this report, is recorded, processed, summarized, and reported within the time periods specified in the SEC's rules and forms. Disclosure controls are also designed to ensure that such information is accumulated and communicated to management, including the Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable, not absolute, assurance of achieving the desired control objectives, as ours are designed to do, and management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

An evaluation was carried out under the supervision and with the participation of the Company's management, including the Chief Executive Officer and the Chief Financial Officer, of the effectiveness of the Company’s disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934) as of September 30, 2012. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company’s disclosure controls and procedures were effective. No changes occurred in the Company’s internal controls over financial reporting during the quarter ended September 30, 2012 that materially affected, or are reasonably likely to materially affect, the internal controls over financial reporting.

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FIRST DEFIANCE FINANCIAL CORP.

PART II-OTHER INFORMATION

Item 1. Legal Proceedings

First Defiance is not engaged in any legal proceedings of a material nature.

Item 1A. Risk Factors

There are no material changes from the risk factors set forth under Part I, Item 1A. “Risk Factors” in the Company’s Annual Report on Form 10-K for the year ended December 31, 2011.

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

First Defiance did not have any common stock repurchases during the first quarter of 2012, but has 93,124 shares that may be purchased under a plan announced by the Board of Directors on July 18, 2003. Prior to the U.S. Treasury sale of its preferred stock of the Company, our participation in the CPP prohibited the Company from repurchasing any of its common shares without the prior approval of the U.S. Treasury. As of June 19, 2012, this prohibition no longer applies.

Item 3. Defaults Upon Senior Securities

Not applicable.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

Not applicable.

Item 6. Exhibits

Exhibit 3.1 Articles of Incorporation (1)

Exhibit 3.2 Code of Regulations (1)

Exhibit 3.4 Amendment to Articles of Incorporation (2)

Exhibit 31.1 Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
Exhibit 31.2 Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

Exhibit 32.1 Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
Exhibit 32.2 Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

(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 exhibit 3 in Form 8-K filed December 8, 2008 (Film No. 081236105)

FIRST DEFIANCE FINANCIAL CORP.

SIGNATURES

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

First Defiance Financial Corp.
(Registrant)

Date: November 9, 2012 By: /s/ William J. Small
William J. Small
Chairman, President and
Chief Executive Officer

Date: November 9, 2012 By: /s/ Donald P. Hileman
Donald P. Hileman
Executive Vice President and
Chief Financial Officer
(Principal Financial Officer)