

FIRST DEFIANCE FINANCIAL CORP  
Form 10-Q  
May 06, 2013

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

**(Mark One)**

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.  
For the Quarterly Period Ended March 31, 2013

OR

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

Commission file number 0-26850

First Defiance Financial Corp.

(Exact name of registrant as specified in its charter)

Ohio 34-1803915  
(State or other jurisdiction of (I.R.S. Employer  
incorporation or organization) Identification Number)

601 Clinton Street, Defiance, Ohio 43512

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(Address of principal executive office) (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   
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 – 9,773,331 shares outstanding at April 30, 2013.

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

(UNAUDITED)

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

	March 31, 2013	December 31, 2012
Assets		
Cash and cash equivalents:		
Cash and amounts due from depository institutions	\$ 31,342	\$ 45,832
Federal funds sold	125,000	91,000
	156,342	136,832
Securities:		
Available-for-sale, carried at fair value	196,132	194,101
Held-to-maturity, carried at amortized cost (fair value \$499 and \$516 at March 31, 2013 and December 31, 2012, respectively)	492	508
	196,624	194,609
Loans held for sale	10,761	22,064
Loans receivable, net of allowance of \$26,459 at March 31, 2013 and \$26,711 at December 31, 2012, respectively	1,480,549	1,498,546
Accrued interest receivable	6,025	5,594
Federal Home Loan Bank stock	19,354	20,655
Bank owned life insurance	42,061	41,832
Premises and equipment	39,218	39,663
Real estate and other assets held for sale	4,313	3,805
Goodwill	61,525	61,525
Core deposit and other intangibles	4,402	4,738
Mortgage servicing rights	8,379	7,833
Deferred taxes	301	78

Other assets	9,557	9,174
Total assets	\$2,039,411	\$ 2,046,948

*(continued)*

## FIRST DEFIANCE FINANCIAL CORP.

## Consolidated Condensed Statements of Financial Condition

(UNAUDITED)

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

	March 31, 2013	December 31, 2012
Liabilities and stockholders' equity		
Liabilities:		
Deposits	\$1,656,348	\$ 1,667,472
Advances from the Federal Home Loan Bank	12,784	12,796
Subordinated debentures	36,083	36,083
Securities sold under repurchase agreements	52,747	51,702
Advance payments by borrowers	1,366	1,473
Other liabilities	17,440	19,294
Total liabilities	1,776,768	1,788,820
Stockholders' equity:		
Preferred stock, \$.01 par value per share: 5,000,000 shares authorized; no shares issued	-	-
Common stock, \$.01 par value per share: 25,000,000 shares authorized; 12,735,313 and 12,739,496 shares issued and 9,766,132 and 9,729,466 shares outstanding, respectively	127	127
Common stock warrant	878	878
Additional paid-in capital	135,925	136,046
Accumulated other comprehensive income, net of tax of \$2,050 and \$2,301, respectively	3,808	4,274
Retained earnings	168,563	164,103
Treasury stock, at cost, 2,969,181 and 3,010,030 shares respectively	(46,658 )	(47,300 )
Total stockholders' equity	262,643	258,128
Total liabilities and stockholders' equity	\$2,039,411	\$ 2,046,948

*See accompanying notes*

## FIRST DEFIANCE FINANCIAL CORP.

## Consolidated Condensed Statements of Income

(UNAUDITED)

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

	Three Months Ended March 31,	
	2013	2012
Interest Income		
Loans	\$ 16,796	\$ 18,650
Investment securities:		
Taxable	678	1,111
Non-taxable	725	672
Interest-bearing deposits	58	92
FHLB stock dividends	219	229
Total interest income	18,476	20,754
Interest Expense		
Deposits	1,647	2,369
FHLB advances and other	90	751
Subordinated debentures	152	331
Securities sold under repurchase agreements	60	104
Total interest expense	1,949	3,555
Net interest income	16,527	17,199
Provision for loan losses	425	3,503
Net interest income after provision for loan losses	16,102	13,696
Non-interest Income		
Service fees and other charges	2,385	2,671
Insurance commission income	3,036	2,536
Mortgage banking income	2,830	2,445
Gain on sale of non-mortgage loans	15	9
Gain on sale or call of securities	53	43
Trust income	163	153
Income from Bank Owned Life Insurance	229	220
Other non-interest income	251	342
Total non-interest income	8,962	8,419
Non-interest Expense		
Compensation and benefits	8,798	8,465
Occupancy	1,654	1,788
FDIC insurance premium	656	669
State franchise tax	629	514
Data processing	1,181	1,169
Amortization of intangibles	336	375
Other non-interest expense	3,945	3,279



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Total non-interest expense	17,199	16,259
Income before income taxes	7,865	5,856
Federal income taxes	2,306	1,703
Net Income	\$ 5,559	\$ 4,153
Dividends accrued on preferred shares	\$ -	\$ (462 )
Accretion on preferred shares	\$ -	\$ (46 )
Net income applicable to common shares	\$ 5,559	\$ 3,645
Earnings per common share (Note 6)		
Basic	\$ 0.57	\$ 0.37
Diluted	\$ 0.55	\$ 0.37
Dividends declared per share (Note 5)	\$ 0.10	\$ 0.05
Average common shares outstanding (Note 6)		
Basic	9,736	9,726
Diluted	10,105	9,970
<i>See accompanying notes</i>		

FIRST DEFIANCE FINANCIAL CORP.

Consolidated Condensed Statements of Comprehensive Income

(UNAUDITED)

(Amounts in Thousands)

	Three Months Ended March 31,	
	2013	2012
	(In thousands)	
Net income	\$ 5,559	\$ 4,153
Other comprehensive income:		
Unrealized losses on securities available for sale	(664 )	(49 )
Reclassification adjustment for security gains included in net income(1)	(53 )	(43 )
Income tax benefit	251	32
Other comprehensive loss	(466 )	(60 )
Comprehensive income	\$ 5,093	\$ 4,093

(1) Amounts are included in gains on sale or call of securities on the Consolidated Condensed Statements of Income. Income tax expense associated with the reclassification adjustments, included in federal income taxes, for the three months ended March 31, 2013 and 2012 was \$16 and \$13, respectively.

## FIRST DEFIANCE FINANCIAL CORP.

## Consolidated Statement of Changes in Stockholders' Equity

(In Thousands, except number of shares)

	Preferred Stock	Common Stock	Common Stock Warrant	Additional Paid-In Capital	Stock Acquired by ESOP	Accumulated Other Comprehensive Income (Loss)	Retained Earnings	Treasury Stock	Total Stockholder's Equity
Balance at January 1, 2013	\$-	\$ 127	\$ 878	\$ 136,046	\$ -	\$ 4,274	\$ 164,103	\$(47,300)	\$ 258,128
Net income							5,559		5,559
Other comprehensive loss						(466 )			(466 )
Stock option expense				19					19
4,870 shares issued under stock option plan, with no income tax benefit, net of repurchases				(9 )			(81 )	142	52
Restricted share activity under stock incentive Plans, including 31,796 shares issued				(131 )			(45 )	500	324
Common stock dividends declared							(973 )		(973 )
Balance at March 31, 2013	\$-	\$ 127	\$ 878	\$ 135,925	\$ -	\$ 3,808	\$ 168,563	\$(46,658)	\$ 262,643
Balance at January 1, 2012	\$ 36,641	\$ 127	\$ 878	\$ 135,825	\$ -	\$ 3,997	\$ 148,010	\$(47,351)	\$ 278,127
Net income							4,153		4,153
Other comprehensive loss						(60 )			(60 )
Stock option expense				34					34
150 shares issued under stock option plan, with no income tax benefit							(1 )	2	1
Restricted share activity under stock incentive plans				29				29	58

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211 shares issued								4	4
direct purchases									
Preferred stock								(462 )	(462 )
dividends accrued									
Accretion on preferred	46							(46 )	-
shares									
Common stock								(491 )	(491 )
dividends declared									
Balance at March 31,	\$36,687	\$ 127	\$ 878	\$135,888	\$ -	\$ 3,937	\$151,163	\$(47,316)	\$ 281,364
2012									

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## FIRST DEFIANCE FINANCIAL CORP.

## Consolidated Condensed Statements of Cash Flows

(UNAUDITED)

(Amounts in Thousands)

	Three Months Ended March 31,	
	2013	2012
<b>Operating Activities</b>		
Net income	\$5,559	\$4,153
Items not requiring (providing) cash		
Provision for loan losses	425	3,503
Depreciation	809	832
Amortization of mortgage servicing rights, net of impairment recoveries	216	942
Amortization of core deposit and other intangible assets	336	375
Net amortization of premiums and discounts on loans and deposits	199	213
Amortization of premiums and discounts on securities	129	164
Change in deferred taxes	27	1,064
Proceeds from the sale of loans held for sale	112,112	109,551
Originations of loans held for sale	(99,395 )	(105,117 )
Gain from sale of loans	(2,191 )	(2,553 )
Loss from sale of property and equipment	1	-
Gain from sale or call of securities	(53 )	(43 )
Loss on sale or write-down of real estate and other assets held for sale	17	197
Stock option expense	19	34
Restricted stock expense	324	58
Income from bank owned life insurance	(229 )	(220 )
Changes in:		
Accrued interest receivable	(431 )	(101 )
Other assets	(383 )	(1,027 )
Other liabilities	(1,854 )	(34 )
Net cash provided by operating activities	15,637	11,991
<b>Investing Activities</b>		
Proceeds from maturities of held-to-maturity securities	16	17
Proceeds from maturities, calls and pay-downs of available-for-sale securities	13,805	16,376
Proceeds from sale of real estate and other assets held for sale	785	286
Proceeds from the sale of available-for-sale securities	1,019	218
Proceeds from sale of non-mortgage loans	3,629	9
Purchases of available-for-sale securities	(17,647 )	(25,639 )
Proceeds from Federal Home Loan stock redemption	1,301	-

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Purchases of premises and equipment, net	(365 )	(1,335 )
Net decrease in loans receivable	12,447	4,716
Net cash provided by (used in) investing activities	14,990	(5,352 )

Financing Activities

Net (decrease) increase in deposits and advance payments by borrowers	(11,229 )	75,048
Repayment of Federal Home Loan Bank advances	(12 )	(11 )
Increase (decrease) in securities sold under repurchase agreements	1,045	(5,777 )
Proceeds from exercise of stock options	52	1
Proceeds from treasury stock purchases	-	4
Cash dividends paid on common stock	(973 )	(491 )
Cash dividends paid on preferred stock	-	(462 )
Net cash provided by (used in) financing activities	(11,117 )	68,312
Increase in cash and cash equivalents	19,510	74,951
Cash and cash equivalents at beginning of period	136,832	174,931
Cash and cash equivalents at end of period	\$ 156,342	\$ 249,882

Supplemental cash flow information:

Interest paid	\$ 1,923	\$ 3,556
Income taxes paid	\$ 3,100	\$ -
Transfers from loans to real estate and other assets held for sale	\$ 1,310	\$ 263
Securities traded but not yet settled	\$ -	\$ 1,212

*See accompanying notes.*

FIRST DEFIANCE FINANCIAL CORP.

Notes to Consolidated Condensed Financial Statements

(Unaudited at March 31, 2013 and 2012)

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

First Defiance Financial Corp. (“First Defiance” or the “Company”) is a unitary thrift holding company that conducts business through its subsidiaries, First Federal Bank of the Midwest (“First Federal”), First Insurance Group of the Midwest, Inc. (“First Insurance”), and First Defiance Risk Management Inc. (collectively, the Subsidiaries”). All significant intercompany transactions and balances are eliminated in consolidation.

First Federal is primarily engaged in community banking 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 and Bowling Green, Maumee and Oregon, Ohio areas, offering property and casualty, and group health and life insurance products. First Defiance Risk Management was incorporated on December 20, 2012, as a wholly-owned insurance company subsidiary of the Company to insure the Company and its subsidiaries against certain risks unique to the operations of the Company and for which insurance may not be currently available or economically feasible in today’s insurance marketplace.

The consolidated condensed statement of financial condition at December 31, 2012 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 March 31, 2013 and for the three month periods ended March 31, 2013 and 2012 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 2012 Annual Report on Form 10-K for the year ended December 31, 2012. 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 month period ended March 31, 2013 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 and accretion of preferred stock discount) by the weighted average number of shares of common stock outstanding during the period. All outstanding unvested share-based payment awards that contain rights to nonforfeitable dividends are considered participating securities for the calculation. Diluted earnings per common share include the dilutive effect of additional potential common shares issuable under stock options, warrants, restricted stock awards or units and stock grants.

## Newly Effective Accounting Standards

In February 2013, the FASB issued ASU 2013-02, "*Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income*." The standard requires that companies present in a single note or parenthetically on the face of the financial statements, the effect of significant amounts reclassified from each component of accumulated other comprehensive income based on its source and the income statement line items affected by the reclassification. The new requirements are effective for public companies in the fiscal years, and interim periods within those years, beginning after December 15, 2012. The Company adopted this standard on January 1, 2013. The effect of adopting this standard increased the Company's disclosure surrounding reclassification items out of accumulated other comprehensive income.

### 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 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.

**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, established 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 asset quality or collections department reviews the assumptions and approaches utilized in the appraisal. Appraisal values are discounted between a range of 0% to 20% to account for other 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:

Assets and Liabilities Measured on a Recurring Basis

<b>March 31, 2013</b>	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>	<b>Total Fair</b>
	<b>Inputs</b>	<b>Inputs</b>	<b>Inputs</b>	<b>Value</b>
	(In Thousands)			
Available for sale securities:				
Obligations of U.S. government corporations and agencies	\$-	\$7,045	\$-	\$ 7,045
U.S. treasury bonds		1,001		1,001
Mortgage-backed - residential	-	38,922	-	38,922
Collateralized mortgage obligations	-	57,163	-	57,163
Trust preferred stock	-	-	1,651	1,651
Preferred stock	251	-	-	251
Corporate bonds	-	8,971	-	8,971
Obligations of state and political subdivisions	-	81,128	-	81,128
Mortgage banking derivative - asset	-	918	-	918
Mortgage banking derivative - liability	-	(223 )	-	(223 )

December 31, 2012	Level 1 Inputs (In Thousands)	Level 2 Inputs	Level 3 Inputs	Total Fair Value
Available for sale securities:				
Obligations of U.S. Government corporations and agencies	\$-	\$11,069	\$-	\$11,069
U.S. treasury bonds	-	1,002	-	1,002
Mortgage-backed – residential	-	31,461	-	31,461
Collateralized mortgage obligations	-	57,466	-	57,466
Trust preferred stock	-	-	1,474	1,474
Preferred stock	134	-	-	134
Corporate bonds	-	8,884	-	8,884
Obligations of state and political subdivisions	-	82,611	-	82,611
Mortgage banking derivative - asset	-	950	-	950
Mortgage banking derivative - liability	-	(94 )	-	(94 )

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 months ended March 31, 2013 and March 31, 2012:

Fair Value Measurements Using Significant Unobservable Inputs (Level 3) (In Thousands)	
Beginning balance, January 1, 2013	\$1,474
Total gains or losses (realized/unrealized)	
Included in earnings (unrealized)	-
Included in other comprehensive income (presented gross of taxes)	177
Amortization	-
Sales	-
Transfers in and/or out of Level 3	-
Ending balance, March 31, 2013	\$1,651

### 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 (unrealized)	-
Included in other comprehensive income (presented gross of taxes)	35
Amortization	-
Sales	-
Transfers in and/or out of Level 3	-
Ending balance, March 31, 2012	\$1,377





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

March 31, 2013	Level 1	Level 2 Inputs Inputs (In Thousands)	Level 3 Inputs	Total Fair Value
Impaired loans				
Residential Loans	\$-	\$ -	\$ 459	\$ 459
Commercial Loans	-	-	1,317	1,317
Home Equity Loans	-	-	164	164
Multi Family Loans	-	-	390	390
CRE loans	-	-	12,653	12,653
Total Impaired loans	-	-	14,983	14,983
Mortgage servicing rights	-	3,609	-	3,609
Real estate held for sale				
Residential Loans	-	-	-	-
CRE loans	-	-	-	-
Total Real Estate held for sale	-	-	-	-

December 31, 2012	Level 1	Level 2 Inputs Inputs (In Thousands)	Level 3 Inputs	Total Fair Value
Impaired loans				
Residential Loans	\$-	\$ -	\$ 599	\$ 599
Commercial Loans	-	-	771	771
Home Equity Loans	-	-	168	168
Multi Family Loans	-	-	407	407
CRE loans	-	-	12,126	12,126
Total Impaired loans	-	-	14,071	14,071
Mortgage servicing rights	-	7,833	-	7,833
Real estate held for sale				
Residential Loans	-	-	61	61
CRE loans	-	-	385	385
Total Real Estate held for sale	-	-	446	446

For Level 3 assets and liabilities measured at fair value on a recurring or nonrecurring basis as of March 31, 2013, the significant unobservable inputs used in the fair value measurements were as follows:

	Fair Value (Dollars in Thousands)	Valuation Technique	Unobservable Inputs	Range of Inputs	
Trust preferred stock	\$ 1,651	Discounted cash flow	Constant prepayment rate	2-40	%
			Expected asset default	0-30	%
			Expected recoveries	10-15	%
Impaired Loans- Applies to all loan classes	\$ 14,983	Appraisals	Discounts for collection issues and changes in market conditions	0-10	%

For Level 3 assets and liabilities measured at fair value on a recurring or nonrecurring basis as of December 31, 2012, the significant unobservable inputs used in the fair value measurements were as follows:

	Fair Value (Dollars in Thousands)	Valuation Technique	Unobservable Inputs	Range of Inputs
Trust preferred stock	\$1,474	Discounted cash flow	Constant prepayment rate	2-40 %
			Expected asset default	0-30 %
			Expected recoveries	10-15 %
Impaired Loans- Applies to all loan classes	\$14,071	Appraisals	Discounts for collection issues and changes in market conditions	0-10 %
Real estate held for sale – Applies to all classes	\$446	Appraisals	Discounts for changes in market conditions	0-20 %

Impaired loans, which are measured for impairment using the fair value of the collateral for collateral dependent loans, had a fair value of \$15.0 million, with no valuation allowance at March 31, 2013. A provision expense of \$621,000 for the three months ended March 31, 2013 was included in earnings.

Mortgage servicing rights which are carried at the lower of cost or fair value had a fair value of \$3.6 million at March 31, 2013, with a valuation allowance of \$1.8 million. A recovery of \$473,000 for the three months ended March 31, 2013 was included in earnings.

Impaired loans, which are measured for impairment using the fair value of the collateral for collateral dependent loans, had a fair value of \$14.1 million with a valuation allowance of \$0 at December 31, 2012. Provision expense of \$4.8 million for the three months ended March 31, 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 December 31, 2012 resulting in a valuation allowance of \$2.3 million. A charge of \$79,000 for the three months ended March 31, 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 \$137,000 for the three months ended March 31, 2012 which was recorded directly as an adjustment to current earnings through non-interest expense.

In accordance with FASB ASC Topic 825, the Fair Value Measurements tables are a comparative condensed consolidated statement of financial condition based on carrying amount and estimated fair values of financial instruments as of March 31, 2013 and December 31, 2012. 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 value.

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 March 31, 2013.

	Carrying Value	Fair Value Measurements at March 31, 2013			
		Total	Level 1	Level 2	Level 3
<b>Financial Assets:</b>					
Cash and cash equivalents	\$156,342	\$156,342	\$156,342	\$-	\$-
Investment securities	196,624	196,631	251	194,729	1,651
Federal Home Loan Bank Stock	19,354	N/A	N/A	N/A	N/A
Loans, net, including loans held for sale	1,491,310	1,509,279	-	11,042	1,498,237
Accrued interest receivable	6,025	6,025	-	1,194	4,831
<b>Financial Liabilities:</b>					
Deposits	\$1,656,348	\$1,659,700	\$291,765	\$1,367,935	\$-
Advances from Federal Home Loan Bank	12,784	13,403	-	13,403	-
Securities sold under repurchase agreements	52,747	52,747	-	52,747	-
Subordinated debentures	36,083	35,292	-	-	35,292

	Carrying Value	Fair Value Measurements at December 31, 2012 (In Thousands)			
		Total	Level 1	Level 2	Level 3
<b>Financial Assets:</b>					
Cash and cash equivalents	\$136,832	\$136,832	\$136,832	\$-	\$-
Investment securities	194,609	194,617	134	193,009	1,474
Federal Home Loan Bank Stock	20,655	N/A	N/A	N/A	N/A
Loans, net, including loans held for sale	1,520,610	1,543,438	-	22,577	1,520,861
Accrued interest receivable	5,594	5,594	-	757	4,837
<b>Financial Liabilities:</b>					
Deposits	\$1,667,472	\$1,671,713	\$315,132	\$1,356,581	\$-
Advances from Federal Home Loan Bank	12,796	13,466	-	13,466	-
Securities sold under repurchase agreements	51,702	51,702	-	51,702	-
Subordinated debentures	36,083	35,766	-	-	35,766

#### 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 March 31, 2013, 291,400 options had been granted and remain outstanding at option prices based on the market value of the underlying shares on the date the options were granted. Options granted under all plans vest 20% per year except for the 2009 grant to the Company's executive officers, which 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.

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

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

Cash and/or equity benefits under the 2011 STIP and LTIP and 2012 STIP were paid out to the selected members of management in the first quarter of 2013 based on the achievement of certain performance targets. One member of management was not paid until April 2013.

In March 2013, the Company approved a 2013 STIP and a 2013 LTIP for selected members of management.

Under the 2013 STIP the participants may earn up to 25% to 45% of their salary for potential payout based on the achievement of certain corporate performance targets during the calendar year. The final amount of benefits under the 2013 STIP will be determined as of December 31, 2013 and will be paid out in cash in the first quarter of 2014. The participants are required to be employed on the day of payout in order to receive such payment.

Under the 2013 LTIP the participants may earn up to 25% to 45% of their salary for potential payout in the form of equity awards based on the achievement of certain corporate performance targets over a three year period. The Company granted 86,065 RSU's to the participants in this Plan effective January 1, 2013, which represents the maximum target award. The amount of benefit under the 2013 LTIP will be determined individually at the 12 month period ending December 31, 2013, the 24 month period ending December 31, 2014 and the 36 month period ending December 31, 2015. The awards' vesting will be as follows: 16.7% of the target award after the end of the performance period ending December 31, 2013, 27.8% of the target award at the end of the performance period ending December 31, 2014 and 55.5% of the target award at the end of the performance period ending December 31, 2015. The benefits earned under the 2013 LTIP Plan will be paid out in equity in the first quarter following the close of the applicable

performance period. The participants are required to be employed on the day of payout in order to receive such payment.

The fair value of each option award is estimated on the date of grant using the Black-Scholes model. Expected volatilities are based on historical volatilities of the Company's common stock. The Company uses historical data to estimate option exercise and post-vesting termination behavior. The expected term of options granted is based on historical data and represents the period of time that options granted are expected to be outstanding, which takes into account that the options are not transferable. The risk-free interest rate for the expected term of the option is based on the U.S. Treasury yield curve in effect at the time of the grant. There were no options granted during the three months ended March 31, 2013 or 2012.

Following is activity under the plans during the three months ended March 31, 2013:

Stock options	<b>Options Outstanding</b>	<b>Weighted Average Exercise Price</b>	<b>Weighted Average Remaining Contractual Term (in years)</b>	<b>Aggregate Intrinsic Value (in 000's)</b>
Options outstanding, January 1, 2013	312,350	\$ 20.33		
Forfeited or cancelled	7,400	20.19		
Exercised	13,550	18.80		
Granted	-	-		
Options outstanding, March 31, 2013	291,400	\$ 20.42	3.90	\$ 1,335
Vested or expected to vest at March 31, 2013	291,400	\$ 20.42	3.90	\$ 1,335
Exercisable at March 31, 2013	250,910	\$ 21.72	3.59	\$ 892

As of March 31, 2013, there was \$35,000 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 1.3 years.

At March 31, 2013, 106,061 RSU's were outstanding. Compensation expense is recognized over the performance period based on the achievements of targets as established with the plan documents. Total accrued expense of \$273,000 was recorded during the three months ended March 31, 2013 and approximately \$262,000 is included within other liabilities at March 31, 2013 related to the STIPs and LTIPs.

Restricted Stock Units	Stock Grants
Weighted-Average Grant Date	Weighted-Average Grant Date

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Unvested Shares	Shares	Fair Value	Shares	Fair Value
Unvested at January 1, 2013	38,871	\$ 14.74	11,260	\$ 13.28
Granted	91,187	19.42	20,639	15.77
Vested	(20,639 )	15.77	(31,899)	14.89
Forfeited	(3,358 )	11.97	-	-
Unvested at March 31, 2013	106,061	\$ 18.66	-	\$ -

The maximum amount of compensation expense that may be recorded for the 2013 STIP and the 2012 and 2013 LTIPs at March 31, 2013 is approximately \$2.5 million. However, the estimated expense expected to be recorded as of March 31, 2013 based on the performance measures in the plans, is \$2.0 million of which \$1.6 million is unrecognized at March 31, 2013 and will be recognized over the remaining performance periods.

## 5. Dividends on Common Stock

First Defiance declared and paid a \$0.10 per common stock dividend in the first quarter of 2013 and declared and paid a \$0.05 per common stock dividend in the first quarter of 2012.

## 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 March 31,	
	2013	2012
Numerator for basic and diluted earnings per common share – Net income applicable to common shares	\$ 5,559	\$ 3,645
Denominator:		
Denominator for basic earnings per common share – weighted average common shares	9,736	9,726
Effect of warrants	295	208
Effect of employee stock options	74	36
Denominator for diluted earnings per common share share	10,105	9,970
Basic earnings per common share	\$ 0.57	\$ 0.37
Diluted earnings per common share	\$ 0.55	\$ 0.37

There were 144,350 shares under option granted to employees excluded from the diluted earnings per common share calculation as they were anti-dilutive for the three months ended March 31, 2013. Shares under option of 256,643 were excluded from the diluted earnings per common share calculations as they were anti-dilutive for the three months ended March 31, 2012.

**7. Investment Securities**

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

	<b>Amortized Cost</b>	<b>Gross Unrealized Gains</b>	<b>Gross Unrealized Losses</b>	<b>Fair Value</b>
	(In Thousands)			
<b>At March 31, 2013</b>				
<b>Available-for-Sale Securities:</b>				
Obligations of U.S. government corporations and agencies	\$7,000	\$ 45	\$ -	\$ 7,045
U.S. treasury bonds	1,000	1	-	1,001
Mortgage-backed securities – residential	37,642	1,284	(4 )	38,922
Collateralized mortgage obligations	55,809	1,374	(20 )	57,163
Trust preferred securities and preferred stock	3,600	216	(1,914 )	1,902
Corporate bonds	8,772	200	(1 )	8,971
Obligations of state and political subdivisions	75,563	5,617	(52 )	81,128
<b>Totals</b>	<b>\$189,386</b>	<b>\$ 8,737</b>	<b>\$ (1,991 )</b>	<b>\$ 196,132</b>
<b>Held-to-Maturity Securities*:</b>				
FHLMC certificates	\$65	\$ -	\$ (1 )	\$ 64
FNMA certificates	153	5	-	158
GNMA certificates	57	3	-	60
Obligations of state and political subdivisions	217	-	-	217
<b>Totals</b>	<b>\$492</b>	<b>\$ 8</b>	<b>\$ (1 )</b>	<b>\$ 499</b>
	<b>Amortized Cost</b>	<b>Gross Unrealized Gains</b>	<b>Gross Unrealized Losses</b>	<b>Fair Value</b>
	(In Thousands)			
<b>At December 31, 2012</b>				
<b>Available-for-sale</b>				
Obligations of U.S. government corporations and agencies	\$11,000	\$ 69	\$ -	\$11,069
U.S. treasury bonds	1,000	2	-	1,002
Mortgage-backed securities - residential	30,020	1,441	-	31,461
Collateralized mortgage obligations	55,962	1,504	-	57,466
Trust preferred stock and preferred stock	3,600	99	(2,091 )	1,608
Corporate bonds	8,717	167	-	8,884
Obligations of state and political subdivisions	76,339	6,277	(5 )	82,611
<b>Total Available-for-Sale</b>	<b>\$186,638</b>	<b>\$ 9,559</b>	<b>\$ (2,096 )</b>	<b>\$194,101</b>
<b>Held-to-Maturity*:</b>				
FHLMC certificates	\$69	\$ -	\$ (1 )	\$ 68

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FNMA certificates	162	6	-	168
GNMA certificates	60	3	-	63
Obligations of states and political subdivisions	217	-	-	217
Total Held-to-Maturity	\$508	\$ 9	\$ (1	) \$516

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

The amortized cost and fair value of the investment securities portfolio at March 31, 2013 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	\$3,255	\$3,275	\$ -	\$ -
Due after one year through five years	10,052	10,324	217	217
Due after five years through ten years	34,479	36,826	-	-
Due after ten years	48,149	49,622	-	-
MBS/CMO	93,451	96,087	275	282
	\$189,386	\$196,134	\$ 492	\$ 499

Investment securities with a carrying amount of \$124.1 million at March 31, 2013 were pledged as collateral on public deposits, securities sold under repurchase agreements, Federal Reserve discount window and FHLB advances.

As of March 31, 2013, the Company’s investment portfolio consisted of 335 securities, 20 of which were in an unrealized loss position.

The following tables summarize First Defiance’s securities that were in an unrealized loss position at March 31, 2013 and December 31, 2012:

	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	Gross Unrealized Losses
	<i>(In Thousands)</i>					
<b>At March 31, 2013</b>						
Available-for-sale securities:						
Mortgage-backed securities - residential	\$2,057	\$ (4 )	\$ -	\$ -	\$2,057	\$ (4 )
Collateralized mortgage obligations	1,961	(20 )	-	-	1,961	(20 )
Obligations of state and political subdivisions	2,902	(52 )	-	-	2,902	(52 )



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Corporate bonds	999	(1 )	-	-	999	(1 )
Trust preferred stock and preferred stock	-	-	1,651	(1,914 )	1,651	(1,914 )
Held-to-maturity securities:						
Mortgage-backed securities - residential	-	-	35	(1 )	35	(1 )
Total temporarily impaired securities	\$7,919	\$ (77 )	\$ 1,686	\$ (1,915 )	\$9,605	\$ (1,992 )

	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, 2012						
Available-for-sale securities:						
Mortgage-backed securities - residential	\$1	\$ -	\$ -	\$ -	\$1	\$ -
Obligations of state and political subdivisions	949	(5 )	-	-	949	(5 )
Trust preferred stock and preferred stock	-	-	1,474	(2,091 )	1,474	(2,091 )
Total temporarily impaired securities	\$950	\$ (5 )	\$ 1,474	\$ (2,091 )	\$2,424	\$ (2,096 )

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 \$53,000 (\$37,000 after tax) in the first quarter of 2013 while there were realized gains of \$43,000 (\$28,000 after tax) in the first quarter of 2012.

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.

In the first quarter of 2013 and 2012, management determined there was no OTTI.

The Company held eight CDOs at March 31, 2013. 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 March 31, 2013. 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.

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. Beginning with the first quarter of 2013, the Company made the decision to only obtain the third party analysis twice a year, June and December, as a result of the stabilization in its current CDO portfolio. Management still obtains the fair value and cash flow value on a quarterly basis and prepares its internal other-than-temporary impairment analysis.

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 other-than-temporary impairment, their lowest credit rating at March 31, 2013 and the related credit losses recognized in earnings for the three month period ended March 31, 2013 (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, 2013	\$ 323	\$ 1,000	\$ 78	\$ 857	\$ 453	\$ 465	\$3,176
Addition – Qtr 1	-	-	-	-	-	-	-
Cumulative OTTI related to credit loss at March 31, 2013	\$ 323	\$ 1,000	\$ 78	\$ 857	\$ 453	\$ 465	\$3,176

The amount of OTTI recognized in accumulated other comprehensive income (“AOCI”) was \$717,000 for the above securities at March 31, 2013. There was \$749,000 recognized in AOCI at December 31, 2012.

The following table provides additional information related to the four CDO investments for which a balance remains as of March 31, 2013 (dollars in thousands):

CDO	Class	Amortized Cost	Fair Value	Unrealized Loss	OTTI Losses 2013	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	673	223	450	-	Caa3	15	43.47 %	17.92 %	-%
I-Preferred Term Sec I	B-1	1,000	631	369	-	CCC	15	7.96 %	23.00 %	25.62 %
Dekania II CDO	C-1	990	548	442	-	CCC	32	-%	13.69 %	29.62 %
Preferred Term Sec XXVII	C-1	902	249	653	-	C	32	27.09 %	22.29 %	6.23 %
Total		\$ 3,565	\$ 1,651	\$ 1,914	\$ -					

The Company's assumed average lifetime default rate declined from 27.9% at the end of the fourth quarter 2012 to a rate of 26.7% at the end of the first quarter 2013.

There were no changes in the accumulated credit losses recognized in earnings for debt securities during the periods ended March 31, 2013 and 2012.

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

	Three Months Ended March 31, 2013 2012	
	(In thousands)	
Proceeds	\$1,019	\$218
Gross realized gains	53	43
Gross realized losses	-	-

**8. Loans**

Loans receivable consist of the following (in thousands):

	March 31, 2013	December 31, 2012
Real Estate:		
Secured by 1-4 family residential	\$ 197,675	\$ 200,826
Secured by multi-family residential	125,526	122,275
Secured by commercial real estate	676,572	675,110
Construction	33,398	37,788
	1,033,171	1,035,999
Other Loans:		
Commercial	365,551	383,817
Home equity and improvement	106,524	108,718
Consumer Finance	15,549	15,936
	487,624	508,471
Total loans	1,520,795	1,544,470
Deduct:		
Undisbursed loan funds	(13,084 )	(18,478 )
Net deferred loan origination fees and costs	(703 )	(735 )
Allowance for loan loss	(26,459 )	(26,711 )
Totals	\$ 1,480,549	\$ 1,498,546

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

March 31, 2013 and 2012 by portfolio segment and impairment method (\$ in thousands):

Quarter Ended March 31, 2013	1-4 Family Residential Real Estate		Construction	Multi- Family Residential Real Estate		Commercial Real Estate	Commercial and Home Equity Improvement	Consumer	Total
Beginning Allowance	\$ 3,506	\$ 75		\$ 2,197	\$ 12,702	\$ 6,325	\$ 1,759	\$ 147	\$ 26,711
Charge-Offs	(206 )	0	0	0	(266 )	(205 )	(272 )	(46 )	(995 )
Recoveries	99	0	0	101	76	23	19	318	
Provisions	34	(8 )	213	830	(892 )	213	35	425	
Ending Allowance	\$ 3,433	\$ 67		\$ 2,410	\$ 13,367	\$ 5,304	\$ 1,723	\$ 155	\$ 26,459



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Quarter Ended March 31, 2012	1-4 Family Residential Real Estate	Construction Residential Real Estate	Multi- Family Residential Real Estate	Commercial Real Estate	Commercial	Home Equity and Improvement	Consumer	Total
Beginning Specific Allocations	\$ 4,095	\$ 63	\$ 2,850	\$ 17,640	\$ 6,576	\$ 1,856	\$ 174	\$33,254
Charge-Offs	(738 )	-	(238 )	(4,258 )	(2,666 )	(211 )	(41 )	(8,152 )
Recoveries	55	-	-	108	30	21	14	228
Provisions	(39 )	10	219	2,710	753	(181 )	31	3,503
Ending Allowance	\$ 3,373	\$ 73	\$ 2,831	\$ 16,200	\$ 4,693	\$ 1,485	\$ 178	\$28,833

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 March 31, 2013:

(In Thousands)

	1-4 Family Residential Real Estate	Construction	Multi- Family Residential Real Estate	Commercial Real Estate	Commercial & Improvement	Home Equity	Consumer	Total
Allowance for loan losses:								
Ending allowance balance attributable to loans:								
Individually evaluated for impairment	\$ 279	\$ -	\$ -	\$ 1,092	\$ 58	\$ 24	\$ -	\$ 1,453
Collectively evaluated for impairment	3,154	67	2,410	12,259	5,245	1,699	155	24,989
Acquired with deteriorated credit quality	-	-	-	16	1	-	-	17
Total ending allowance balance	\$ 3,433	\$ 67	\$ 2,410	\$ 13,367	\$ 5,304	\$ 1,723	\$ 155	\$ 26,459
Loans:								
Loans individually evaluated for impairment	\$ 11,336	\$ -	\$ 1,264	\$ 44,730	\$ 8,194	\$ 2,888	\$ 82	\$ 68,494
Loans collectively evaluated for impairment	186,785	20,308	125,597	632,167	358,402	104,116	15,464	1,442,839

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Loans acquired with deteriorated credit quality	34	-	-	432	30	-	-	496
Total ending loans balance	\$ 198,155	\$ 20,308	\$ 126,861	\$ 677,329	\$ 366,626	\$ 107,004	\$ 15,546	\$ 1,511,829

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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, 2012:

(In Thousands)

	1-4 Family Residential Real Estate	Construction	Multi- Family Residential Real Estate	Commercial Real Estate	Commercial & Improvement	Home Equity	Consumer	Total
Allowance for loan losses:								
Ending allowance balance attributable to loans:								
Individually evaluated for impairment	\$ 281	\$ -	\$ -	\$ 1,070	\$ 138	\$ 2	\$ -	\$ 1,491
Collectively evaluated for impairment	3,225	75	2,197	11,632	6,187	1,757	147	25,220
Acquired with deteriorated credit quality	-	-	-	-	-	-	-	-
Total ending allowance balance	\$ 3,506	\$ 75	\$ 2,197	\$ 12,702	\$ 6,325	\$ 1,759	\$ 147	\$ 26,711
Loans:								
Loans individually evaluated for impairment	\$ 11,930	\$ 45	\$ 1,626	\$ 46,053	\$ 8,830	\$ 2,678	\$ 124	\$ 71,286
Loans collectively evaluated for impairment	189,348	19,251	120,829	630,534	376,007	106,516	15,815	1,458,300

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Loans acquired with deteriorated credit quality	36	-	-	436	32	-	-	504
Total ending loans balance	\$ 201,314	\$ 19,296	\$ 122,455	\$ 677,023	\$ 384,869	\$ 109,194	\$ 15,939	\$ 1,530,090

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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 March 31, 2013		
	Average Balance	Interest Income Recognized	Cash Basis Income Recognized
Residential Owner Occupied	\$ 6,947	\$ 88	\$ 86
Residential Non Owner Occupied	4,669	35	35
Total Residential Real Estate	11,616	123	121
Construction	22	-	-
Multi-Family	1,444	7	7
CRE Owner Occupied	14,701	62	58
CRE Non Owner Occupied	24,318	203	193
Agriculture Land	926	9	7
Other CRE	5,369	1	1
Total Commercial Real Estate	45,314	275	259
Commercial Working Capital	1,487	4	5
Commercial Other	6,981	23	22
Total Commercial	8,468	27	27
Consumer	104	2	2
Home Equity and Home Improvement	2,772	34	32
Total Impaired Loans	\$ 69,740	\$ 468	\$ 448

	Three Months Ended March 31, 2012		
	Average Balance	Interest Income Recognized	Cash Basis Income Recognized
Residential Owner Occupied	\$ 1,931	\$ 13	\$ 12
Residential Non Owner Occupied	2,728	23	23
Total Residential Real Estate	4,659	36	35
Construction	80	-	-
Multi-Family	2,288	16	16
CRE Owner Occupied	9,476	13	12
CRE Non Owner Occupied	15,580	91	71
Agriculture Land	1,441	14	14
Other CRE	8,044	1	1
Total Commercial Real Estate	34,541	119	98
Commercial Working Capital	2,210	3	3
Commercial Other	4,786	5	5
Total Commercial	6,996	8	8
Consumer	-	-	-
Home Equity and Home Improvement	38	1	1
Total Impaired Loans	\$ 48,602	\$ 180	\$ 158

The following table presents loans individually evaluated for impairment by class of loans as of March 31, 2013: *(In Thousands)*

	Unpaid Principal Balance*	Recorded Investment	Allowance for Loan Losses Allocated
With no allowance recorded:			
Residential Owner Occupied	\$ 5,153	\$ 5,103	\$ -
Residential Non Owner Occupied	3,942	3,206	-
Total Residential Real Estate	9,095	8,309	-
Construction	-	-	-
Multi-Family Residential Real Estate	1,413	1,264	-
CRE Owner Occupied	12,200	9,849	-
CRE Non Owner Occupied	10,717	7,707	-
Agriculture Land	1,039	1,082	-
Other CRE	9,224	5,664	-
Total Commercial Real Estate	33,180	24,302	-
Commercial Working Capital	964	662	-
Commercial Other	5,781	5,723	-
Total Commercial	6,745	6,385	-
Consumer	79	79	-
Home Equity and Home Improvement	2,626	2,492	-
Total loans with no allowance recorded	\$ 53,138	\$ 42,831	\$ -
With an allowance recorded:			
Residential Owner Occupied	\$ 1,753	\$ 1,760	\$ 256
Residential Non Owner Occupied	1,265	1,267	23
Total Residential Real Estate	3,018	3,027	279
Construction	-	-	-
Multi-Family Residential Real Estate	-	-	-
CRE Owner Occupied	5,676	5,055	240
CRE Non Owner Occupied	15,135	15,201	847
Agriculture Land	111	114	3
Other CRE	86	58	2
Total Commercial Real Estate	21,008	20,428	1,092
Commercial Working Capital	-	-	-
Commercial Other	1,805	1,809	58
Total Commercial	1,805	1,809	58
Consumer	3	3	-
Home Equity and Home Improvement	395	396	24
Total loans with an allowance recorded	\$ 26,229	\$ 25,663	\$ 1,453

\*Unpaid principal balance includes partial 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, 2012:  
(In Thousands)

	Unpaid Principal Balance*	Recorded Investment	Allowance for Loan Losses Allocated
With no allowance recorded:			
Residential Owner Occupied	\$ 5,427	\$ 5,357	\$ -
Residential Non Owner Occupied	4,211	3,420	-
Total Residential Real Estate	9,638	8,777	-
Construction	300	45	-
Multi-Family Residential Real Estate	1,775	1,626	-
CRE Owner Occupied	12,314	9,782	-
CRE Non Owner Occupied	11,054	9,105	-
Agriculture Land	1,176	993	-
Other CRE	8,741	5,527	-
Total Commercial Real Estate	33,285	25,407	-
Commercial Working Capital	1,565	1,565	-
Commercial Other	6,367	5,338	-
Total Commercial	7,932	6,903	-
Consumer	125	124	-
Home Equity and Home Improvement	2,777	2,642	-
Total loans with no allowance recorded	\$ 55,832	\$ 45,524	\$ -
With an allowance recorded:			
Residential Owner Occupied	\$ 1,697	\$ 1,701	\$ 257
Residential Non Owner Occupied	1,449	1,452	24
Total Residential Real Estate	3,146	3,153	281
Construction	-	-	-
Multi-Family Residential Real Estate	-	-	-
CRE Owner Occupied	5,735	5,118	245
CRE Non Owner Occupied	15,301	15,357	820
Agriculture Land	111	112	3
Other CRE	88	59	2
Total Commercial Real Estate	21,235	20,646	1,070
Commercial Working Capital	300	301	10
Commercial Other	1,623	1,626	128
Total Commercial	1,923	1,927	138
Consumer	-	-	-
Home Equity and Home Improvement	36	36	2
Total loans with an allowance recorded	\$ 26,340	\$ 25,762	\$ 1,491

\*Unpaid principal balance includes partial 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:

	March 31, December 31,	
	2013	2012
	(in thousands)	
Non-accrual loans	\$35,283	\$ 32,570
Loans over 90 days past due and still accruing	-	-
Total non-performing loans	35,283	32,570
Real estate and other assets held for sale	4,313	3,805
Total non-performing assets	\$39,596	\$ 36,375

The following table presents the aging of the recorded investment in past due and non accrual loans as of March 31, 2013 by class of loans: *(In Thousands)*

	Current	30-59 days	60-89 days	90+ days	Total Past Due	Total Non Accrual
Residential Owner Occupied	\$122,921	\$ 1,418	\$ 83	\$1,420	\$ 2,921	\$ 1,594
Residential Non Owner Occupied	70,247	865	524	677	2,066	2,566
Total Residential Real Estate	193,168	2,283	607	2,097	4,987	4,160
Construction	20,308	-	-	-	-	-
Multi-Family	126,813	-	-	48	48	1,189
CRE Owner Occupied	319,908	2,779	365	3,483	6,627	10,402
CRE Non Owner Occupied	232,445	225	423	2,723	3,371	7,583
Agriculture Land	73,371	109	28	82	219	770
Other Commercial Real Estate	37,111	-	-	4,277	4,277	4,930
Total Commercial Real Estate	662,835	3,113	816	10,565	14,494	23,685
Commercial Working Capital	151,607	10	-	762	772	1,121
Commercial Other	209,562	246	1,187	3,252	4,685	5,037
Total Commercial	361,169	256	1,187	4,014	5,457	6,158
Consumer	15,425	117	4	-	121	-
Home Equity/Home Improvement	106,035	325	560	84	969	84
Total Loans	\$1,485,753	\$ 6,094	\$ 3,174	\$ 16,808	\$ 26,076	\$ 35,276



The following table presents the aging of the recorded investment in past due and non accrual loans as of December 31, 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	\$ 125,362	\$ 1,238	\$ 604	\$ 945	\$ 2,787	\$ 1,125
Residential Non Owner Occupied	71,777	413	126	849	1,388	2,473
<b>Total Residential Real Estate</b>	<b>197,139</b>	<b>1,651</b>	<b>730</b>	<b>1,794</b>	<b>4,175</b>	<b>3,598</b>
Construction	19,296	-	-	-	-	-
Multi-Family	122,455	-	-	-	-	1,178
CRE Owner Occupied	321,071	1,248	382	1,622	3,252	9,652
CRE Non Owner Occupied	235,592	134	1,321	2,480	3,935	6,674
Agriculture Land	72,092	84	31	-	115	813
Other Commercial Real Estate	36,510	21	875	3,560	4,456	4,761
<b>Total Commercial Real Estate</b>	<b>665,265</b>	<b>1,487</b>	<b>2,609</b>	<b>7,662</b>	<b>11,758</b>	<b>21,900</b>
Commercial Working Capital	161,110	-	155	1,204	1,359	1,528
Commercial Other	218,477	584	1,201	2,138	3,923	4,136
<b>Total Commercial</b>	<b>379,587</b>	<b>584</b>	<b>1,356</b>	<b>3,342</b>	<b>5,282</b>	<b>5,664</b>
Consumer	15,702	229	8	-	237	-
Home Equity/Home Improvement	106,458	2,294	225	217	2,736	217
<b>Total Loans</b>	<b>\$ 1,505,902</b>	<b>\$ 6,245</b>	<b>\$ 4,928</b>	<b>\$ 13,015</b>	<b>\$ 24,188</b>	<b>\$ 32,557</b>

### Troubled Debt Restructurings

As of March 31, 2013 and December 31, 2012, the Company has a recorded investment in troubled debt restructurings (“TDRs”) of \$34.0 million and \$35.5 million, respectively. The Company has allocated \$1.1 million of specific reserves to those loans at each of March 31, 2013 and December 31, 2012, and has committed to lend additional amounts totaling up to \$35,000 and \$41,000 at March 31, 2013 and December 31, 2012, respectively.

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. All retail loans where the borrower is in bankruptcy are classified as TDRs regardless of whether or not a concession is made.

Of the loans modified in a TDR, \$6.0 million are on non-accrual status and partial charge-offs have in some cases 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 troubled debt restructurings that occurred during the three month period ending March 31, 2013 and March 31, 2012:

Troubled Debt Restructurings	Loans Modified as a TDR for the Three Months Ended March 31, 2013 (\$ in thousands)	
	Number of Loans	Recorded Investment (as of period end)
Residential Owner Occupied	4	\$ 367
Residential Non Owner Occupied	1	198
CRE Owner Occupied	1	29
CRE Non Owner Occupied	0	-
Agriculture Land	1	219
Other CRE	0	0
Commercial / Industrial	1	14
Home Equity / Improvement	8	492
Consumer	2	4
Total	18	\$ 1,323

The loans described above increased the ALLL by \$19,000 in the three month period ending March 31, 2013.



Loans Modified as a TDR for the Three  
Months Ended March 31, 2012  
(\$ in thousands)

Troubled Debt Restructurings	Number of Loans	Recorded Investment (as of period end)
Residential Owner Occupied	2	\$ 148
Residential Non Owner Occupied	1	83
CRE Owner Occupied	2	951
CRE Non Owner Occupied	0	-
Agriculture Land	1	339
Other CRE	0	-
Commercial / Industrial	0	-
Home Equity / Improvement	0	-
Consumer	0	-
Total	6	\$ 1,521

The loans described above decreased the ALLL by \$15,000, after charge-offs of \$700,000, in the three month period ending March 31, 2012.

The following table presents loans by class modified as TDRs for which there was a payment default within twelve months following the modification during the quarter ending March 31, 2013:

	Three Months Ended March 31, 2013	
Troubled Debt Restructurings That Subsequently Defaulted:	Number of Loans	Recorded Investment (as of Period End)
Residential Owner Occupied	4	\$ 312
Residential Non Owner Occupied	1	198
CRE Owner Occupied	2	858
CRE Non Owner Occupied	-	-
Agriculture Land	-	-
Other CRE	-	-
Commercial / Industrial	2	744
Home Equity / Improvement	4	53
Consumer	-	-
Total	13	\$ 2,165

The TDRs that subsequently defaulted described above decreased the allowance for loan losses by \$1,000 for the period ended March 31, 2013, after \$0 charge-offs.

There were no loans that defaulted within the three months ended March 31, 2012 which had been modified within one year of the default date. A default for the purposes of this disclosure is a TDR loan in which the borrower is 90 days or more past due.

The terms of certain other loans were modified during the period ending March 31, 2013 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 42 loans were modified under this definition during the three month period ended March 31, 2013.

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

### **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 March 31, 2013, and based on the most recent analysis performed, the risk category of loans by class of loans is as follows: (*In Thousands*)



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Category	Pass	Special Mention	Substandard	Doubtful	Not Graded	Total
Residential Owner Occupied	\$4,043	\$42	\$ 3,861	\$ 90	\$117,805	\$125,841
Residential Non Owner Occupied	54,810	3,658	7,009	-	6,837	72,314
Total Residential Real Estate	58,853	3,700	10,870	90	124,642	198,155
Construction	12,844	129	-	-	7,335	20,308
Multi-Family	122,566	751	2,538	-	1,006	126,861
CRE Owner Occupied	297,600	10,464	18,360	-	110	326,534
CRE Non Owner Occupied	202,862	11,351	21,454	-	149	235,816
Agriculture Land	71,412	606	1,573	-	-	73,591
Other Commercial Real Estate	31,137	2,067	7,324	-	860	41,388
Total Commercial Real Estate	603,011	24,488	48,711	-	1,119	677,329
Commercial Working Capital	146,445	4,131	1,803	-	-	152,379
Commercial Other	202,218	4,830	7,199	-	-	214,247
Total Commercial	348,663	8,961	9,002	-	-	366,626
Consumer	-	-	90	-	15,456	15,546
Home Equity/Home Improvement	-	-	835	24	106,145	107,004
Total Loans	\$1,145,937	\$38,029	\$ 72,046	\$ 114	\$255,703	\$1,511,829

As of December 31, 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	\$4,221	\$75	\$ 3,617	\$ 234	\$120,002	\$128,149
Residential Non Owner Occupied	55,771	2,453	8,248	-	6,693	73,165
Total Residential Real Estate	59,992	2,528	11,865	234	126,695	201,314
Construction	11,360	-	45	-	7,891	19,296
Multi-Family	118,121	910	2,404	-	1,020	122,455
CRE Owner Occupied	292,765	10,440	18,740	-	2,378	324,323
CRE Non Owner Occupied	207,745	9,077	22,615	-	90	239,527
Agriculture Land	69,924	769	1,514	-	-	72,207
Other Commercial Real Estate	31,875	891	7,222	-	978	40,966
Total Commercial Real Estate	602,309	21,177	50,091	-	3,446	677,023
Commercial Working Capital	156,433	3,587	2,449	-	-	162,469
Commercial Other	208,783	5,204	8,413	-	-	222,400
Total Commercial	365,216	8,791	10,862	-	-	384,869
Consumer	-	-	70	-	15,869	15,939
Home Equity/Home Improvement	-	-	668	64	108,462	109,194
Total Loans	\$1,156,998	\$33,406	\$ 76,005	\$ 298	\$263,383	\$1,530,090

Beginning with the first quarter of 2013 allowance analysis, management decided to return to using a twelve quarter look-back period, from using an eight quarter look-back period that has been used since December 31, 2010, for calculating the historical loss ratio. Management is not certain that the relatively low levels of charge-offs incurred in recent quarters are sustainable given the low levels of economic growth in its markets and believes the longer look-back period better captures loan portfolio risks at this time.

**9. Mortgage Banking**

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

	Three Months Ended March 31,	
	2013	2012
	(in thousands)	
Gain from sale of mortgage loans	\$ 2,176	\$ 2,544
Mortgage loans servicing revenue (expense):		
Mortgage loans servicing revenue	870	844
Amortization of mortgage servicing rights	(689 )	(864 )
Mortgage servicing rights valuation adjustments	473	(79 )
	654	(99 )
Net revenue from sale and servicing of mortgage loans	\$ 2,830	\$ 2,445

The unpaid principal balance of residential mortgage loans serviced for third parties was \$1.4 billion at March 31, 2013 and \$1.3 billion at December 31, 2012.

Activity for capitalized mortgage servicing rights and the related valuation allowance follows for the three months ended March 31, 2013 and 2012:

	March 31, March 31,	
	2013	2012
	(in thousands)	
Mortgage servicing assets:		
Balance at beginning of period	\$10,121	\$ 10,219
Loans sold, servicing retained	762	749
Amortization	(689 )	(864 )
Carrying value before valuation allowance at end of period	10,194	10,106
Valuation allowance:		
Balance at beginning of period	(2,288 )	(1,529 )
Impairment (expense) recovery	473	(79 )
Balance at end of period	(1,815 )	(1,608 )
Net carrying value of MSR's at end of period	\$8,379	\$ 8,498
Fair value of MSR's at end of period	\$8,436	\$ 8,498

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

Included in the first quarter of 2013 is an accrual for estimated secondary market buy-back losses of \$581,000 compared to no losses accrued for the same period in 2012. These losses were accrued and expensed as of March 31, 2013 based on an estimated exposure to repurchase requests resulting from notifications received from Fannie Mae's post-foreclosure review process during the first quarter of 2013.



**10. Deposits**

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

	March 31, 2013	December 31, 2012
Non-interest-bearing checking accounts	\$291,765	\$ 315,132
Interest-bearing checking and money market accounts	681,061	664,857
Savings accounts	177,336	166,945
Retail certificates of deposit less than \$100,000	330,870	342,472
Retail certificates of deposit greater than \$100,000	173,379	176,029
Brokered or national certificates of deposit	1,937	2,037
	\$1,656,348	\$ 1,667,472

**11. Borrowings**

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

	March 31, 2013	December 31, 2012
	(in thousands)	
FHLB Advances:		
Putable advances	\$12,000	\$ 12,000
Amortizable mortgage advances	784	796
Total	\$12,784	\$ 12,796
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. \$12.0 million of the putable advances with a weighted average rate of 2.72% were not yet callable by the FHLB at March 31, 2013. The call dates for these advances range from April 15, 2013 to June 12, 2013 and the maturity dates range from January 14, 2015 to March 12, 2018. Putable advances are callable at the option of the FHLB on a quarterly basis.

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 1.5%. The Coupon rate payable on the Trust Preferred Securities issued by Trust Affiliate II was 1.78% as of March 31, 2013 and 1.89% as of December 31, 2012.

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 1.66% and 1.77% on March 31, 2013 and December 31, 2012 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):



	March 31, 2013		December 31, 2012	
	Fixed Rate	Variable Rate	Fixed Rate	Variable Rate
Commitments to make loans	\$53,174	\$ 74,184	\$50,205	\$ 48,035
Unused lines of credit	23,236	238,257	21,975	228,269
Standby letters of credit	-	21,388	-	18,166
Total	\$76,410	\$ 333,829	\$72,180	\$ 294,470

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 \$37.8 million and \$53.6 million of loans to Freddie Mac, Fannie Mae, Federal Home Loan Bank of Cincinnati or BB&T Mortgage at March 31, 2013 and December 31, 2012, 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 2008. 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 \$30.2 million and \$34.0 million of interest rate lock commitments at March 31, 2013 and December 31, 2012, respectively. There were \$37.8 million and \$53.6 million of forward commitments for the future delivery of residential mortgage loans at March 31, 2013 and December 31, 2012, 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:

March 31, 2013	December 31, 2012
Assets (Liabilities)	Assets (Liabilities)

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	Carrying	Carrying	Derivative	Carrying	Carrying	Derivative
	Value	Value	Net	Value	Value	Net
	(In Thousands)		Carrying			Carrying
			Value			Value
Derivatives not designated as hedging instruments						
Mortgage Banking Derivatives	\$918	\$ (223 )	\$ 695	\$950	\$ (94 )	\$ 856

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  
 March 31,  
 2013          2012  
 (In Thousands)

Derivatives not designated as hedging instruments

Mortgage Banking Derivatives – Gain (Loss)          \$ (161 ) \$ 273

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

**Note 15 - Other Comprehensive Income (Loss)**

The before and after tax amounts allocated to each component of other comprehensive income (loss) are presented in the table below. Reclassification adjustments related to securities available for sale are included in gains on sale or call of securities in the accompanying consolidated condensed statements of income.

	Before Tax Amount	Tax Expense (Benefit)	Net of Tax Amount
Three months ended March 31, 2013:			
Securities available for sale and transferred securities:			
Change in net unrealized gain/loss during the period	\$ (664 )	\$ (235 )	\$ (429 )
Reclassification adjustment for net gains included in net income	(53 )	(16 )	(37 )
Total other comprehensive loss	\$ (717 )	\$ (251 )	\$ (466 )
Three months ended March 31, 2012:			
Securities available for sale and transferred securities:			
Change in net unrealized gain/loss during the period	\$ (49 )	\$ (19 )	\$ (30 )
Reclassification adjustment for net gains included in net income	(43 )	(13 )	(30 )
Total other comprehensive loss	\$ (92 )	\$ (32 )	\$ (60 )

Activity in accumulated other comprehensive income (loss), net of tax, was as follows:

	Securities Available For Sale	Post- retirement Benefit	Accumulated Other Comprehensive Income
Balance January 1, 2013	\$ 4,851	\$ (577 )	\$ 4,274
Other comprehensive loss before reclassifications	(429 )	-	(429 )
Amounts reclassified from accumulated other comprehensive loss	(37 )	-	(37 )
Net other comprehensive loss during period	(466 )	-	(466 )
Balance March 31, 2013	\$ 4,385	\$ (577 )	\$ 3,808
Balance January 1, 2012	\$ 4,704	\$ (707 )	\$ 3,997
Other comprehensive loss before reclassifications	(30 )	-	(30 )
Amounts reclassified from accumulated other comprehensive loss	(30 )	-	(30 )
Net other comprehensive loss during period	(60 )	-	(60 )
Balance March 31, 2012	\$ 4,644	\$ (707 )	\$ 3,937



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 Exchange 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 subsidiaries, First Federal, First Insurance and First Defiance Risk Management. First Federal is a federally chartered stock savings bank that provides financial services to communities through 33 full service banking centers in communities based in northwest Ohio, northeast Indiana, and southeastern Michigan. 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 areas. First Defiance Risk Management is a wholly-owned insurance company subsidiary of the Company that insures the Company and its subsidiaries against certain risks unique to the operations of the Company and for which insurance may not be currently available or economically feasible in today’s insurance marketplace. First Defiance Risk Management pools resources with several other similar insurance company subsidiaries of financial institutions to spread a limited amount of risk among themselves. First Defiance Risk Management was incorporated on December 20, 2012.

**Impact of Legislation** - Over the last several years, Congress and the U.S. Department of the Treasury have enacted legislation and taken actions to address the disruptions in the financial system, declines in the housing market, and the overall regulation of financial institutions and the financial system. In this regard, the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”), includes provisions affecting large and small financial institutions alike, including several provisions that profoundly affect the regulation of community banks, thrifts, and bank and thrift holding companies, such as First Defiance. Also, the Dodd-Frank Act abolished the Office of Thrift Supervision effective July 21, 2011 and transferred its functions to the Office of the Comptroller of the Currency (“OCC”), FDIC, and Federal Reserve. The Dodd-Frank Act relaxed rules regarding interstate branching, allows financial institutions to pay interest on business checking accounts, changed the scope of federal deposit insurance coverage,

imposed new capital requirements on bank and thrift holding companies, and imposed limits on debit card interchange fees charged by issuer banks (commonly known as the Durbin Amendment).

The Dodd-Frank Act also established the Consumer Financial Protection Bureau (“CFPB”) as an independent bureau within the Federal Reserve, which has broad authority to regulate consumer financial products and services and entities offering such products and services, including banks. Many of the consumer financial protection functions formerly assigned to the federal banking and other designated agencies are now performed by the CFPB. The CFPB has broad rulemaking authority over providers of credit, savings, and payment services and products. In this regard, the CFPB has the authority to implement regulations under federal consumer protection laws and enforce those laws against, and examine, financial institutions. State officials also will be authorized to enforce consumer protection rules issued by the CFPB. This bureau also is authorized to collect fines and provide consumer restitution in the event of violations, engage in consumer financial education, track consumer complaints, request data, and promote the availability of financial services to underserved consumers and communities. The CFPB also is directed to prevent “unfair, deceptive or abusive practices” and ensure that all consumers have access to markets for consumer financial products and services and that such markets are fair, transparent, and competitive. Although the CFPB has begun to implement its regulatory, supervisory, examination, and enforcement authority, there continues to be significant uncertainty as to how the agency’s strategies and priorities will impact First Defiance.

The CFPB has indicated that mortgage lending is an area of supervisory focus and that it will concentrate its examination and rulemaking efforts on the variety of mortgage-related topics required under the Dodd-Frank Act, including steering consumers to less-favorable products, discrimination, abusive or unfair lending practices, predatory lending, origination disclosures, minimum mortgage underwriting standards, mortgage loan originator compensation, and servicing practices. The CFPB recently published several final regulations impacting the mortgage industry, including rules related to ability-to-pay, mortgage servicing, and mortgage loan originator compensation. The ability-to-repay rule makes lenders liable if they fail to assess ability to repay under a prescribed test, but also creates a safe harbor for so called “qualified mortgages.” The “qualified mortgages” standards include a tiered cap structure that places limits on the total amount of certain fees that can be charged on a loan, a 43% cap on debt-to-income (i.e., total monthly payments on debt to monthly gross income), exclusion of interest-only products, and other requirements. The 43% debt-to-income cap does not apply for the first seven years the rule is in effect for loans that are eligible for sale to Fannie Mae or Freddie Mac or eligible for government guarantee through the FHA or the Veterans Administration. Failure to comply with the ability-to-repay rule may result in possible CFPB enforcement action and special statutory damages plus actual, class action, and attorney fees damages, all of which a borrower may claim in defense of a foreclosure action at any time. First Defiance’s management team is currently assessing the impact of these requirements on our mortgage lending business.

In addition, the Federal Reserve and other federal bank regulatory agencies have issued a proposed rule under the Dodd-Frank Act that would exempt “qualified residential mortgages” from the securitization risk retention requirements of the Dodd-Frank Act. The final definition of what constitutes a “qualified residential mortgage” may impact the pricing and depth of the secondary market into which the Company may sell mortgages it originates. At this time, First Defiance cannot predict the content of the final CFPB and other federal agency regulations or the impact they might have on First Defiance’s financial results. The CFPB’s authority over mortgage lending, and its authority to change regulations adopted in the past by other regulators, or to rescind or ignore past regulatory guidance, could increase First Defiance’s compliance costs and litigation exposure.

First Defiance's management team continues to actively monitor the implementation of the Dodd-Frank Act and the regulations promulgated thereunder and assess its probable impact on the business, financial condition, and results of operations of First Defiance. However, the ultimate effect of the Dodd-Frank Act on the financial services industry in general, and First Defiance in particular, continues to be uncertain.

**New Proposed Capital Rules** - On June 7, 2012, the Federal Reserve approved proposed rules that would substantially amend the regulatory risk-based capital rules applicable to First Defiance and First Federal. The FDIC and the OCC subsequently approved these proposed rules on June 12, 2012. The proposed rules implement the "Basel III" regulatory capital reforms and changes required by the Dodd-Frank Act. "Basel III" refers to two consultative documents released by the Basel Committee on Banking Supervision in December 2009, the rules text released in December 2010, and loss absorbency rules issued in January 2011, which include significant changes to bank capital, leverage and liquidity requirements. The proposed rules received extensive comments during a comment period that ran through October 2012. In November 2012, the federal bank regulatory agencies jointly stated that they do not expect any of the proposed rules to become effective on the original target date of January 1, 2013. Further guidance from the bank regulatory agencies is expected in 2013.

The proposed rules include new risk-based capital and leverage ratios, which would be phased in from 2013 to 2019, and would refine the definition of what constitutes "capital" for purposes of calculating those ratios. The proposed new minimum capital level requirements applicable to First Defiance and First Federal under the proposals would be: (i) a new common equity Tier 1 capital ratio of 4.5%; (ii) a Tier 1 capital ratio of 6% (increased from 4%); (iii) a total capital ratio of 8% (unchanged from current rules); and (iv) a Tier 1 leverage ratio of 4% for all institutions. The proposed rules would also establish a "capital conservation buffer" of 2.5% above the new regulatory minimum capital requirements, which must consist entirely of common equity Tier 1 capital and would result in the following minimum ratios: (i) a common equity Tier 1 capital ratio of 7.0%, (ii) a Tier 1 capital ratio of 8.5%, and (iii) a total capital ratio of 10.5%. The new capital conservation buffer requirement would be phased in beginning in January 2016 at 0.625% of risk-weighted assets and would increase by that amount each year until fully implemented in January 2019.

The federal bank regulatory agencies also proposed revisions to the prompt corrective action framework, which is designed to place restrictions on insured depository institutions, including First Federal, if their capital levels begin to show signs of weakness. These revisions would take effect January 1, 2015. Under the prompt corrective action requirements, which are designed to complement the capital conservation buffer, insured depository institutions would be required to meet the following increased capital level requirements in order to qualify as "well capitalized:" (i) a new common equity Tier 1 capital ratio of 6.5%; (ii) a Tier 1 capital ratio of 8% (increased from 6%); (iii) a total capital ratio of 10% (unchanged from current rules); and (iv) a Tier 1 leverage ratio of 5% (increased from 4%). The proposed rules set forth certain changes for the calculation of risk-weighted assets, which we would be required to utilize beginning January 1, 2015. The standardized approach proposed rule utilizes an increased number of credit risk exposure categories and risk weights, and also addresses: (i) a proposed alternative standard of creditworthiness consistent with Section 939A of the Dodd-Frank Act; (ii) revisions to recognition of credit risk mitigation; (iii) rules for risk weighting of equity exposures and past due loans; (iv) revised capital treatment for derivatives and repo-style transactions; and (v) disclosure requirements for top-tier banking organizations with \$50 billion or more in total assets that are not subject to the "advance approach rules" that apply to banks with greater than \$250 billion in consolidated

assets.

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Based on our current capital composition and levels, management believes we would be in compliance with the requirements as set forth in the proposed rules if they were presently in effect.

**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 2013, management intends to continue to focus on asset quality, core deposit growth, expense control as well as other opportunities to further service our customers.

**Commercial and Commercial Real Estate Lending** - Commercial and commercial real estate lending have been an ongoing focus and a major component of First Federal's success. First Federal provides primarily commercial real estate and commercial business loans with an emphasis on owner occupied commercial real estate and commercial business lending with a focus on the deposit balances that accompany these relationships. First Federal's client base tends to be small to middle market customers with annual gross revenues generally between \$1 million and \$50 million. First Federal's focus is also on securing multiple guarantors in addition to collateral where possible. These customers require First Federal to have a high degree of knowledge and understanding of their business in order to provide them with solutions to their financial needs. First Federal's "Customer First" philosophy and culture complements 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 financial institutions in the past with the most recent acquisition completed in 2008. First Defiance will continue to be disciplined as well as opportunistic in its approach to future acquisitions and de novo branching with a focus on its primary geographic market area, which it knows well and has been competing in for a long period of time. First Defiance will also continue the same approach as state above for insurance acquisitions. First Defiance completed its most recent insurance acquisition 2011, which was merged into First Insurance.





**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 \$492,000 at March 31, 2013. 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 \$196.1 million at March 31, 2013. The available-for-sale portfolio consists of obligations of U.S. Government corporations and agencies (\$7.0 million), certain municipal obligations (\$81.1 million), CMOs (\$57.2 million), corporate bonds (\$9.0 million), mortgage backed securities (\$38.9 million), U.S. treasury bonds (\$1.0 million) and trust preferred and preferred stock (\$1.9 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 most instances, if the appraisal is more than twelve to fifteen months old, we may require a new appraisal. Finally, First Federal assesses whether there is any collateral short fall, taking into consideration guarantor support and liquidity, and determines if a charge off is necessary.

When a collateral dependent loan moves to non-performing status, First Federal generally gets a new third party appraisal and charges the loan down appropriately 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 and charge offs 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 are classified as non-performing loans. Non-performing status automatically occurs in the month in which the 90 day delinquency occurs.

As stated above, once a collateral dependent loan is identified as non-performing, First Federal generally gets an appraisal.

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 charge off decisions 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. First Federal may consider moving the loan to accruing status after approximately 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 loan to value quarterly to determine accuracy and any necessary charge offs. Based on these results, changes may occur in the processes used.

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 Troubled Debt Restructurings, First Federal either computes the present value of expected future cash flows discounted at the original loan's effective interest rate or it may measure impairment based on the fair value of the collateral. For those loans measured for impairment utilizing the present value of future cash flows method, any discount is carried as a reserve in the allowance for loan and lease losses. For those loans measured for impairment utilizing the fair value of the collateral, any shortfall is charged off.

**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.

### **Changes in Financial Condition**

At March 31, 2013, First Defiance's total assets, deposits and stockholders' equity amounted to \$2.04 billion, \$1.66 billion and \$262.6 million, respectively, compared to \$2.05 billion, \$1.67 billion and \$258.1 million, respectively, at December 31, 2012.

Net loans receivable (excluding loans held for sale) declined \$18.0 million to \$1.48 billion. The variance in loans receivable between March 31, 2013 and December 31, 2012 include decreases in commercial loans (down \$18.2 million), home equity and improvement loans (down \$2.2 million), consumer loans (down \$0.4 million), one to four family residential real estate loans (down \$3.2 million), and construction loans (down \$4.4 million) while commercial real estate loans increased \$4.7 million.

The investment securities portfolio increased \$2.0 million to \$196.6 million at March 31, 2013 from \$194.6 million at December 31, 2012. The increase is the result of \$18.8 million of securities being purchased during the first three months of 2013, mostly offset by \$5.2 million of securities maturing or being called in the period, principal pay downs of \$8.6 million in CMOs and mortgage-backed securities, and \$966,000 from one security being sold. There was an unrealized gain in the investment portfolio of \$6.7 million at March 31, 2013 compared to an unrealized gain of \$7.5 million at December 31, 2012.

Deposits decreased from \$1.67 billion at December 31, 2012 to \$1.66 billion as of March 31, 2013. Non-interest bearing demand deposits decreased \$23.4 million to \$291.8 million, retail time deposits decreased \$14.3 million to \$504.2 million and broker/national certificates of deposit decreased \$100,000 to \$1.9 million. These decreases were mostly offset by increases in interest-bearing demand deposits and money market accounts of \$16.2 million to \$681.1 million and savings accounts of \$10.4 million to \$177.3 million.

Stockholders' equity increased from \$258.1 million at December 31, 2012 to \$262.6 million at March 31, 2013. The increase in stockholders' equity was the result of recording net income of \$5.6 million partially offset by \$973,000 of common stock dividends being paid in the first quarter of 2013 and a \$466,000 decline in other comprehensive income.

**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).

	<b>Three Months Ended March 31,</b>					
	<b>2013</b>			<b>2012</b>		
	<b>Average</b>	<b>Yield/</b>		<b>Average</b>	<b>Yield/</b>	
	<b>Balance</b>	<b>Interest(1)</b>	<b>Rate(2)</b>	<b>Balance</b>	<b>Interest(1)</b>	<b>Rate(2)</b>
<b>Interest-earning assets:</b>						
Loans receivable	\$ 1,500,222	\$ 16,814	4.55 %	\$ 1,456,807	\$ 18,678	5.16 %
Securities	196,571	1,794	3.85	237,541	2,145	3.76
Interest bearing deposits	106,332	58	0.22	164,390	92	0.23
FHLB stock	19,964	219	4.45	20,655	229	4.46
Total interest-earning assets	1,823,089	18,885	4.22	1,879,393	21,144	4.54
Non-interest-earning assets	204,817			201,109		
Total assets	\$2,027,906			\$2,080,502		
<b>Interest-bearing liabilities:</b>						
Deposits	\$ 1,356,547	\$ 1,647	0.49 %	\$ 1,365,021	\$ 2,369	0.70 %
FHLB advances and other	12,788	90	2.85	81,834	751	3.69
Securities sold under repurchase agreements	46,396	60	0.52	53,403	104	0.78
Subordinated debentures	36,136	152	1.71	36,198	331	3.68
Total interest-bearing liabilities	1,451,867	1,949	0.54	1,536,456	3,555	0.93
Non-interest bearing deposits	294,225	-		245,254	-	
Total including non-interest bearing demand deposits	1,746,092	1,949	0.45	1,781,710	3,555	0.80
Other non-interest-bearing liabilities	22,189			18,944		
Total liabilities	1,768,281			1,800,654		
Stockholders' equity	259,625			279,848		
Total liabilities and stock- holders' equity	\$2,027,906			\$2,080,502		
Net interest income; interest rate spread		\$ 16,936	3.68 %		\$ 17,589	3.61 %
Net interest margin (3)			3.78 %			3.78 %
Average interest-earning assets to average interest-bearing liabilities			126 %			122 %

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

## **Results of Operations**

### **Three Months Ended March 31, 2013 and 2012**

On a consolidated basis, First Defiance's net income for the quarter ended March 31, 2013 was \$5.6 million compared to net income of \$4.2 million for the comparable period in 2012. Net income applicable to common shares was \$5.6 million for the first quarter of 2013 compared to \$3.6 million for the comparable period in 2012. On a per share basis, basic and diluted earnings per common share for the three months ended March 31, 2013 were \$0.57 and \$0.55, respectively, compared to basic and diluted earnings per common share of \$0.37 for the quarter ended March 31, 2012.

### **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.

Net interest income was \$16.5 million for the quarter ended March 31, 2013, down from \$17.2 for the same period in 2012. The tax-equivalent net interest margin was 3.78% for the quarter ended March 31, 2013, flat for the same period in 2012. The flat margin between the 2012 and 2013 first quarters was made possible by a balance sheet restructure done in the fourth quarter of 2012, where the Company sold securities and paid off higher rate FHLB advances. This helped to offset the decrease in interest-earning asset yields, which decreased by 32 basis points (to 4.22% in the first quarter of 2013 from 4.54% for the same period in 2012) which was partially offset by the cost of interest-bearing liabilities between the two periods decreasing 39 basis points (to 0.54% in the first quarter of 2013 from 0.93% in the same period in 2012). Also, operating at a high level of liquidity along with lower loan yields has impacted the net interest margin negatively in the first quarter of 2013. Management continues to analyze and look for additional opportunities to maintain its margin, as well as other alternatives to minimize the impact of the sustained low rate environment.

Total interest income decreased by \$2.3 million or 11.0% to \$18.5 million for the quarter ended March 31, 2013 from \$20.8 million for the same period in 2012. 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 4.55% at March 31, 2013. Interest income from loans decreased to \$16.8 million for the quarter ended March 31, 2013 compared to \$18.7 million for the same period in 2012, which represents a decline of 9.9%.



Interest expense decreased by \$1.6 million in the first quarter of 2013 compared to the same period in 2012, to \$1.9 million from \$3.6 million. This decrease was due to a 39 basis point decline in the average cost of interest-bearing liabilities in the first quarter of 2013 mainly due to the early payoff of FHLB advances as part of the balance sheet restructure completed in the fourth quarter of 2012 and the continued low rate environment resulting in decreases in rate on all the interest-bearing liability categories. Interest expense related to interest-bearing deposits was \$1.6 million in the first quarter of 2013 compared to \$2.4 million for the same period in 2012. Interest expense recognized by the Company related to subordinated debentures was \$152,000 in the first quarter of 2013 compared to \$331,000 for the same period in 2012. Expenses on FHLB advances and securities sold under repurchase agreements were \$90,000 and \$60,000 respectively in the first quarter of 2013 compared to \$751,000 and \$104,000 respectively for the same period in 2012.

## Allowance for Loan Losses

The allowance for loan losses represents management's assessment of the estimated probable credit losses in the loan portfolio at each balance sheet date. Management analyzes the adequacy of the allowance for loan losses regularly through reviews of the loan portfolio. Consideration is given to economic conditions, changes in interest rates and the effect of such changes on collateral values and borrower's ability to pay, changes in the composition of the loan portfolio and trends in past due and non-performing loan balances. The allowance for loan losses is a material estimate that is susceptible to significant fluctuation and is established through a provision for loan losses based on management's evaluation of the inherent risk in the loan portfolio. In addition to extensive in-house loan monitoring procedures, the Company utilizes an outside party to conduct an independent loan review of all commercial loan and commercial real estate loan relationships that exceed \$1.0 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 incurred 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 that are cash flow dependent, yet there is a discount between the present value of the future cash flows and the carrying value. This was \$1.5 million at March 31, 2013. 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.

Due to regulatory guidance, the Company no longer carries specific reserves on collateral dependent loans, and instead charges off any shortfall. 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 charge off to be taken.

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 twelve quarters ending March 31, 2013. Beginning with the first quarter of 2013 allowance analysis, management decided to return to using a twelve quarter look-back period, from using an eight quarter look-back period, for calculating the historical loss ratio. Management is not certain that the relatively low levels of charge-offs incurred in recent quarters are sustainable given the low levels of economic growth in its markets and believes the longer look-back period better captures loan portfolio risks at this time.

The stratification of the loan portfolio resulted in a quantitative general allowance of \$13.5 million at March 31, 2013 compared to \$14.4 million at December 31, 2012. The decrease in the quantitative allowance was due to a decrease in the historical loss factors relating to commercial, commercial real estate, residential and consumer loans.

In addition to the quantitative analysis, a qualitative analysis is performed each quarter to provide additional general reserves on the non-impaired loan portfolio for various factors. The overall qualitative factors are based on nine sub-factors. The nine sub-factors have been aggregated into three qualitative factors: economic, environment and risk.

#### ECONOMIC

- 1) Changes in international, national and local economic business conditions and developments, including the condition of various market segments.
- 2) Changes in the value of underlying collateral for collateral dependent loans.

#### ENVIRONMENT

- 3) Changes in the nature and volume in the loan portfolio.
- 4) The existence and effect of any concentrations of credit and changes in the level of such concentrations.
- 5) Changes in lending policies and procedures, including underwriting standards and collection, charge-off and recovery practices.
- 6) Changes in the quality and breadth of the loan review process.
- 7) Changes in the experience, ability and depth of lending management and staff.

#### RISK

- 8) Changes in the trends of the volume and severity of delinquent and classified loans, and changes in the volume of non-accrual loans, trouble debt restructuring, and other loan modifications.
- 9) Changes in the political and regulatory environment.

The qualitative analysis at March 31, 2013 indicated a general reserve of \$11.5 million compared with \$10.8 million at December 31, 2012. Management reviewed the overall economic, environmental and risk factors and determined that it was appropriate to increase several of these due to the continued uncertainty of the economy and the impact on GDP of the fiscal cliff decisions as well as the impacts of the debt ceiling negotiations. The fluctuation in unemployment rates in some of the counties we serve also contributed to an increase in the economic factors. Finally the risk profile was increased due to a continued focus by our regulators for stability in the allowance levels. First Defiance's general reserve percentages for main loan segments not otherwise classified ranged from 0.20% for construction loans to 1.90% for nonresidential real estate loans.

As a result of the quantitative and qualitative analyses, along with the change in specific reserves, the Company's provision for loan losses for the first quarter of 2013 was \$425,000, compared to \$3.5 million for the same period in 2012. The allowance for loan losses was \$26.5 million and \$26.7 million and represented 1.76% and 1.75% of loans, net of undisbursed loan funds and deferred fees and costs, as of March 31, 2013 and December 31, 2012, respectively. The provision of \$425,000 was offset by charge offs of \$995,000 and recoveries of \$318,000, resulting in a decrease to the overall allowance for loan loss of \$252,000. In management's opinion, the overall allowance for loan losses of \$26.5 million as of March 31, 2013 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 three month period ended March 31, 2013, First Defiance had no write-downs. Management believes that the values recorded at March 31, 2013 for real estate owned and repossessed assets represent the realizable value of such assets.

Total classified loans decreased to \$72.3 million at March 31, 2013, compared to \$78.1 million at December 31, 2012.

First Defiance's ratio of allowance for loan losses to non-performing loans was 75.0% at March 31, 2013 compared with 82.0% at December 31, 2012. Management monitors collateral values of all loans included on the watch list that are collateral dependent and believes that allowances for those loans at March 31, 2013 are appropriate. The Company experienced an increase in non-accrual loans in the first quarter of 2013. However, of the total non-accrual loans, \$18.5 million or 52.4% are less than 90 days past due.

At March 31, 2013, First Defiance had total non-performing assets of \$39.6 million, compared to \$36.4 million at December 31, 2012. Non-performing assets include loans that are 90 days past due, real estate owned and other assets held for sale. Non-performing assets at March 31, 2013 and December 31, 2012 by category were as follows:

Table 1 – Nonperforming Asset

	March 31, 2012	December 31, 2012		
	(In thousands)			
Non-performing loans:				
Single-family residential	\$4,163	\$ 3,602		
Construction	-	-		
Non-residential and multi-family residential real estate	24,884	23,090		
Commercial	6,152	5,661		
Consumer finance	-	-		
Home equity and improvement	84	217		
Total non-performing loans	35,283	32,570		
Real estate owned and repossessed assets	4,313	3,805		
Total non-performing assets	\$39,596	\$ 36,375		
Allowance for loan losses as a percentage of total loans*	1.76	%	1.75	%
Allowance for loan losses as a percentage of non-performing assets	66.82	%	73.43	%
Allowance for loan losses as a percentage of non-performing loans	74.99	%	82.01	%
Total non-performing assets as a percentage of total assets	1.94	%	1.78	%
Total non-performing loans as a percentage of total loans*	2.34	%	2.14	%

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

The increase in non-performing loans between December 31, 2012 and March 31, 2013 is primarily in commercial real estate loans. The balance of this type of non-performing loan was \$1.8 million higher at March 31, 2013 compared to December 31, 2012.

Non-performing loans in the commercial real estate category represented 3.10% of the total loans in those categories at March 31, 2013 compared to 2.90% for the same category at December 31, 2012. Management believes that the current allowance for loan losses is appropriate and that the provision for loan losses recorded in the first quarter of 2013 is consistent with both charge-off experience and the risk inherent in the overall credits in the portfolio.

Non-performing assets, which include non-performing loans (non-accrual) and real estate owned, increased to \$39.6 million at March 31, 2013 from \$36.4 million at December 31, 2012.

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 proposed charge-offs which are approved by the Senior Loan Committee or the Loan Loss Reserve Committee.

The following table details net charge-offs and nonaccrual loans by loan type. For the three months ended and as of March 31, 2013, commercial real estate, which represented 52.74% of total loans, accounted for 24.37% of net charge-offs and 70.53% of nonaccrual loans, and commercial loans, which represented 24.04% of total loans, accounted for 19.05% of net charge-offs and 17.44% of nonaccrual loans. For the three months ended and as of March 31, 2012, commercial real estate, which represented 53.10% of total loans, accounted for 55.38% of net charge-offs and 72.91% of nonaccrual loans, and commercial loans, which represented 21.97% of total loans, accounted for 33.27% of net charge-offs and 16.80% of nonaccrual loans.

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

	For the Three Months Ended March 31, 2013		As of March 31, 2013		
	Net Charge-offs (in thousands)	% of Total Net Charge-offs	Nonaccrual Loans (in thousands)	% of Total Non-Accrual Loans	
Residential	\$ 107	15.81	% \$ 4,163	11.80	%
Construction	-	0.00	% -	0.00	%
Commercial real estate	165	24.37	% 24,884	70.53	%
Commercial	129	19.05	% 6,152	17.44	%
Consumer	27	3.99	% -	0.00	%
Home equity and improvement	249	36.78	% 84	0.23	%
Total	\$ 677	100.00	% \$ 35,283	100.00	%

  

	For the Three Months Ended March 31, 2012		As of March 31, 2012		
	Net Charge-offs (in thousands)	% of Total Net Charge-offs	Nonaccrual Loans (in thousands)	% of Total Non-Accrual Loans	
Residential	\$ 683	8.63	% \$ 3,883	8.56	%
Construction	-	0.00	% 159	0.35	%
Commercial real estate	4,388	55.38	% 33,065	72.91	%
Commercial	2,636	33.27	% 7,618	16.80	%
Consumer	27	0.33	% 5	0.01	%
Home equity and improvement	190	2.39	% 621	1.37	%
Total	\$ 7,924	100.00	% \$ 45,351	100.00	%

Table 3 – Allowance for Loan Loss Activity

For the Quarter Ended  
 1st 2013 4th 2012 3rd 2012 2nd 2012 1st 2012  
 (dollars in thousands)



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Allowance at beginning of period	\$26,711	\$26,310	\$26,409	\$28,833	\$33,254
Provision for credit losses	425	2,619	705	4,097	3,503
Charge-offs:					
Residential	206	976	217	584	738
Commercial real estate	266	595	780	5,448	4,496
Commercial	205	540	355	486	2,666
Consumer finance	46	59	19	14	41
Home equity and improvement	272	497	203	254	211
Total charge-offs	995	2,667	1,574	6,786	8,152
Recoveries	318	449	770	265	228
Net charge-offs	677	2,218	804	6,521	7,924
Ending allowance	\$26,459	\$26,711	\$26,310	\$26,409	\$28,833

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

Table 4 – Allowance for Loan Loss Allocation by Loan Category

	March 31, 2013		December 31, 2012		September 30, 2012		June 30, 2012		March 31, 2012		
	Amount	Percent of total loans by category	Amount	Percent of total loans by category	Amount	Percent of total loans by category	Amount	Percent of total loans by category	Amount	Percent of total loans by category	
	(dollars in thousands)										
Residential	\$3,433	13.00 %	\$3,506	13.00 %	\$2,996	13.75 %	\$3,104	13.94 %	\$3,373	13.58 %	
Construction	67	2.20 %	75	2.45 %	63	2.06 %	48	1.52 %	73	2.44 %	
Commercial real estate	15,777	52.74 %	14,899	51.63 %	16,260	51.87 %	16,562	51.33 %	19,031	53.10 %	
Commercial	5,304	24.04 %	6,325	24.85 %	5,103	23.92 %	5,087	24.64 %	4,693	21.97 %	
Consumer	155	1.02 %	147	1.03 %	147	1.10 %	140	1.13 %	178	1.19 %	
Home equity and improvement	1,723	7.00 %	1,759	7.04 %	1,741	7.30 %	1,468	7.44 %	1,485	7.72 %	
	\$26,459	100.00 %	\$26,711	100.00 %	\$26,310	100.00 %	\$26,409	100.00 %	\$28,833	100.00 %	

**Key Asset Quality Ratio Trends**

Table 5 – Key Asset Quality Ratio Trends

	1st Qtr 2013	4th Qtr 2012	3rd Qtr 2012	2nd Qtr 2012	1st Qtr 2012
Allowance for loan losses / loans*	1.76 %	1.75 %	1.74 %	1.76 %	1.96 %
Allowance for loan losses to net charge-offs	3908.27 %	1204.83 %	3272.39 %	404.98 %	363.87 %
Allowance for loan losses / non-performing assets	66.82 %	73.43 %	64.73 %	58.38 %	59.13 %
Allowance for loan losses / non-performing loans	74.99 %	82.01 %	69.60 %	63.33 %	63.58 %
Non-performing assets / loans plus REO*	2.62 %	2.38 %	2.68 %	3.01 %	3.30 %

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Non-performing assets / total assets	1.94	%	1.78	%	1.98	%	2.19	%	2.28	%
Net charge-offs / average loans (annualized)	0.18	%	0.59	%	0.22	%	1.78	%	2.18	%

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

**Non-Interest Income.**

Total non-interest income increased \$543,000 in the first quarter of 2013 to \$9.0 million from \$8.4 million for the same period in 2012.

**Service Fees.** Service fees and other charges decreased by \$286,000 or 10.7% in the first quarter of 2013 compared to the same period in 2012.

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 March 31, 2013 and 2012 related to the overdraft privilege product, net of adjustments to the allowance for uncollectible overdrafts, were \$865,000 and \$1.1 million, respectively. Accounts charged off are included in noninterest expense. The allowance for uncollectible overdrafts was \$6,000 at March 31, 2013, \$4,000 at December 31, 2012 and \$19,000 at March 31, 2012.

***Mortgage Banking Activity.*** Total revenue from the sale and servicing of mortgage loans increased \$385,000 to \$2.8 million for the first quarter of 2013 compared to \$2.4 million for the same period of 2012. The continuing low rate environment helped contribute to solid first quarter of 2013 mortgage originations, although mortgage originations were down slightly from the same period of 2012. Gains realized from the sale of mortgage loans decreased in the first quarter of 2013 to \$2.2 million from \$2.5 million in the first quarter of 2012. The amortization of mortgage servicing rights expense decreased \$175,000 to \$689,000 in the first quarter of 2013 compared to \$864,000 in the same period in 2012. The Company recorded a positive valuation adjustment of \$473,000 on mortgage servicing rights in the first quarter of 2013 compared to a negative valuation adjustment of \$79,000 in the first quarter of 2012. The positive valuation adjustment in the first quarter of 2013 was driven by an increase in the fair values of certain sectors of the Company's portfolio of mortgage servicing rights. The increase in fair values was driven by a slight increase in market rates in the first quarter of 2013 which also contributed to lower amortization of mortgage servicing rights in the first quarter of 2013.

***Insurance and Investment Sales Commissions.*** Income from the sale of insurance and investment products increased \$500,000 in the first quarter of 2013 to \$3.0 million from \$2.5 million in the same period of 2012. First Defiance's insurance subsidiary, First Insurance, typically recognizes contingent revenues during the first quarter. These revenues are bonuses paid by insurance carriers when the Company achieves certain loss ratios or growth targets. In the first quarter of 2013, First Insurance earned \$944,000 of contingent income compared to \$504,000 for the first quarter of 2012.

***Impairment of Securities.*** First Defiance did not have any other-than-temporary impairment ("OTTI") charges in the first quarter of 2013 or in the first quarter of 2012 reflecting a more stable environment relating to its Trust Preferred Collateralized Debt Obligation ("CDO") investments.

**Other non-interest income.** Other non-interest income decreased \$91,000 in the first quarter of 2013 from \$342,000 in the same period in 2012. This decrease was due in part to a recorded increase in the value of the assets of the deferred compensation plan of \$78,000 in the first quarter of 2013 compared to an increase of \$137,000 for the same period in 2012.

#### **Non-Interest Expense.**

Non-interest expense increased to \$17.2 million for the first quarter of 2013 compared to \$16.3 million for the same period in 2012.

**Compensation and Benefits.** Compensation and benefits increased to \$8.8 million for the quarter ended March 31, 2013 from \$8.5 million for the same period in 2012. The increase is mainly attributable to higher health insurance costs. Also, the Company granted pay increases and accrued for bonus payments based on meeting 2013 targeted performance in the first quarter of 2013.

**Other Non-Interest Expenses.** Other non-interest expenses increased by \$666,000 to \$3.9 million for the quarter ended March 31, 2013 from \$3.3 million for the same period in 2012. The main increase between the 2013 and 2012 first quarters include an accrual for estimated secondary market buy-back losses of \$581,000 in the first quarter of 2013 compared to no losses accrued for the same period in 2012. These losses were accrued and expensed as of March 31, 2013 based on an estimated exposure to repurchase requests resulting from notifications received from Fannie Mae's post-foreclosure review process during the first quarter of 2013. Also, the Company expensed \$98,000 in the first quarter of 2013 resulting from a sales and use tax audit from the period of 2009-2011.

The efficiency ratio, considering tax equivalent interest income and excluding securities gains and losses, for the first quarter of 2013 was 66.55% compared to 62.62% for the first quarter of 2012.

#### **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 29.32% for the quarter ended March 31, 2013 compared to 29.08% for the same period in 2012. 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.

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 \$15.6 million of cash provided by operating activities during the first three months of 2013. 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 March 31, 2013, First Federal had \$127.4 million in outstanding loan commitments and loans in process to be funded generally within the next six months and an additional \$282.9 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 \$37.8 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.

### 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.

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 March 31, 2013 (in thousands).

	Actual		Minimum Required for Adequately Capitalized		Minimum Required for Well Capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
Tier 1 Capital (1)						
Consolidated	\$232,332	11.79%	\$ 78,803	4.0 %	N/A	N/A
First Federal Bank	\$221,084	11.24%	\$ 78,672	4.0 %	\$ 98,340	5.0 %

Tier 1 Capital (to Risk Weighted Assets)  
(1)

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Consolidated	\$232,332	13.92%	\$ 66,738	4.0 %	N/A	N/A
First Federal Bank	\$221,084	13.27%	\$ 66,652	4.0 %	\$ 99,979	6.0 %

Total Capital (to Risk Weighted Assets)

(1)

Consolidated	\$253,258	15.19%	\$ 133,477	8.0 %	N/A	N/A
First Federal Bank	\$241,982	14.52%	\$ 133,305	8.0 %	\$ 166,631	10.0 %

Core capital is computed as a percentage of adjusted total assets of \$1.97 billion and \$1.97 billion for consolidated (1) and the bank, respectively. Risk-based capital is computed as a percentage of total risk-weighted assets of \$1.67 billion and \$1.67 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, Goodwill, 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 three months of 2013.

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk**

As discussed in detail in the 2012 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 March 31, 2013 amounts as a base case, First Defiance's net interest income would be impacted by less than the board mandated guidelines of 10%.

In addition to the simulation analysis, First Defiance also 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 March 31, 2013 was considered to be remote given the current interest rate environment and therefore, was not included in this analysis but management believed it to be prudent to include a down 100 basis point environment. The results of this analysis are reflected in the following tables for the three months ended March 31, 2013 and the year-ended December 31, 2012.



March 31, 2013

Economic Value of Equity

Change in Rates	\$ Amount	\$ Change	% Change	
	(Dollars in Thousands)			
+400 bp	407,168	38,862	10.55	%
+ 300 bp	400,369	32,063	8.71	%
+ 200 bp	391,896	23,590	6.41	%
+ 100 bp	382,108	13,803	3.75	%
0 bp	368,306	—	—	
- 100 bp	342,787	(25,519 )	(6.93	)%

December 31, 2012

Economic Value of Equity

Change in Rates	\$ Amount	\$ Change	% Change	
	(Dollars in Thousands)			
+400 bp	415,094	46,835	12.72	%
+ 300 bp	407,337	39,078	10.61	%
+ 200 bp	398,150	29,891	8.12	%
+ 100 bp	387,482	19,223	5.22	%
0 bp	368,259	—	—	
- 100 bp	343,745	(24,514 )	(6.66	)%

**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 March 31, 2013. 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 March 31, 2013 that materially affected, or are reasonably likely to materially affect, the internal controls over financial reporting.



FIRST DEFIANCE FINANCIAL CORP.

## **PART II-OTHER INFORMATION**

### **Item 1. Legal Proceedings**

Neither First Defiance nor any of its subsidiaries is 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, 2012.

### **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 2013, but has 93,124 shares that may be purchased under a plan announced by the Board of Directors on July 18, 2003.

### **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 3.3 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: May 6, 2013 By: /s/ William J. Small  
William J. Small  
Chairman, President and  
Chief Executive Officer

Date: May 6, 2013 By: /s/ Donald P. Hileman  
Donald P. Hileman  
Executive Vice President and  
Chief Financial Officer