FIRST DEFIANCE FINANCIAL CORP
Form 10-Q
November 02, 2010
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

x **Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934. For the Quarterly Period Ended September 30, 2010**

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 incorporation or organization)	**(I.R.S. Employer Identification Number)**
601 Clinton Street, Defiance, Ohio	**43512**
(Address or 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 ¨ No ¨

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

Large accelerated filer ¨	Accelerated filer x
Non-accelerated filer ¨	Smaller reporting company ¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No x

APPLICABLE ONLY TO CORPORATE ISSUERS

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practical date. Common Stock, $.01 Par Value 8,117,770 shares outstanding at October 29, 2010.

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PART 1-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)

	September 30, 2010	December 31, 2009
Assets		
Cash and cash equivalents:		
Cash and amounts due from depository institutions	**$ 31,662**	$ 29,613
Interest-bearing deposits	**117,000**	91,503
	148,662	121,116
Securities:		
Available-for-sale, carried at fair value	**156,355**	137,458
Held-to-maturity, carried at amortized cost (fair value $947 and $1,958 at September 30, 2010 and December 31, 2009, respectively)	**918**	1,920
	157,273	139,378
Loans held for sale	**21,613**	10,346
Loans receivable, net of allowance of $41,343 at September 30, 2010 and $36,547 at December 31, 2009, respectively	**1,508,334**	1,580,575
Accrued interest receivable	**7,248**	6,851
Federal Home Loan Bank stock	**21,376**	21,376
Bank owned life insurance	**32,751**	30,804
Premises and equipment	**42,276**	43,597
Real estate and other assets held for sale	**11,127**	13,527
Goodwill	**57,556**	56,585
Core deposit and other intangibles	**6,485**	6,888
Mortgage servicing rights	**8,289**	8,958
Deferred taxes	**4,865**	3,289
Other assets	**14,384**	14,233
Total assets	**$ 2,042,239**	$ 2,057,523

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FIRST DEFIANCE FINANCIAL CORP.

Consolidated Condensed Statements of Financial Condition

(UNAUDITED)

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

	September 30, 2010	December 31, 2009
Liabilities and stockholders equity		
Liabilities:		
Deposits	**$ 1,590,648**	$ 1,580,226
Advances from the Federal Home Loan Bank	**116,896**	146,927
Securities sold under repurchase agreements	**41,923**	48,398
Subordinated debentures	**36,083**	36,083
Advance payments by borrowers	**501**	665
Other liabilities	**15,159**	11,138
Total liabilities	**1,801,210**	1,823,437
Stockholders equity:		
Preferred stock, $.01 par value per share: 37,000 shares authorized and issued with a liquidation preference of $37,236, net of discount	**36,418**	36,293
Preferred stock, $.01 par value per share: 4,963,000 shares authorized; no shares issued		
Common stock, $.01 par value per share: 25,000,000 shares authorized; 12,739,496 and 12,739,496 shares issued and 8,117,770 and 8,117,520 shares outstanding, respectively	**127**	127
Common stock warrant	**878**	878
Additional paid-in capital	**140,808**	140,677
Accumulated other comprehensive income (loss), net of tax of $1,184 and $(85), respectively	**2,198**	(158)
Retained earnings	**133,228**	128,900
Treasury stock, at cost, 4,621,726 and 4,621,976 shares respectively	**(72,628)**	(72,631)
Total stockholders equity	**241,029**	234,086
Total liabilities and stockholders equity	**$ 2,042,239**	$ 2,057,523

See accompanying notes

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FIRST DEFIANCE FINANCIAL CORP.

Consolidated Condensed Statements of Income

(UNAUDITED)

(Amounts in Thousands, except per share data)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	**2009**	**2010**	**2009**
Interest Income				
Loans	**$ 22,230**	$ 23,766	**$ 67,104**	$ 70,229
Investment securities:				
Taxable	**1,022**	949	**3,091**	3,028
Non-taxable	**512**	473	**1,465**	1,360
Interest-bearing deposits	**68**	41	**198**	89
FHLB stock dividends	**225**	258	**678**	726
Total interest income	**24,057**	25,487	**72,536**	75,432
Interest Expense				
Deposits	**4,667**	6,163	**15,192**	20,206
FHLB advances and other	**1,187**	1,267	**3,625**	3,865
Subordinated debentures	**332**	344	**982**	1,139
Notes payable	**109**	140	**329**	433
Total interest expense	**6,295**	7,914	**20,128**	25,643
Net interest income	**17,762**	17,573	**52,408**	49,789
Provision for loan losses	**5,196**	8,051	**17,525**	14,762
Net interest income after provision for loan losses	**12,566**	9,522	**34,883**	35,027
Non-interest Income				
Service fees and other charges	**3,301**	3,577	**9,856**	9,989
Insurance commission income	**1,421**	1,129	**3,838**	3,945
Mortgage banking income	**2,322**	980	**5,114**	7,677
Gain on sale of non-mortgage loans	**10**	151	**97**	251
Gain on sale or call of securities		154	**6**	279
Other-than-temporary impairment (OTTI) losses on investment securities				
Total impairment losses on investment securities	**(190)**	(1,052)	**(331)**	(2,780)
Losses recognized in other comprehensive income		58		239
Net impairment loss recognized in earnings	**(190)**	(994)	**(331)**	(2,541)
Trust income	**118**	101	**372**	306
Income from Bank Owned Life Insurance	**226**	201	**917**	338
Other non-interest income	**271**	257	**167**	475

Total non-interest income	**7,479**	5,556	**20,036**	20,719
Non-interest Expense				
Compensation and benefits	**7,114**	6,551	**20,161**	21,501
Occupancy	**1,734**	1,860	**5,264**	5,901
FDIC insurance premium	**907**	649	**2,881**	2,713
State franchise tax	**542**	571	**1,621**	1,668
Data processing	**1,186**	1,100	**3,556**	3,330
Acquisition related charges	**16**		**53**	
Amortization of intangibles	**356**	355	**1,139**	1,101
Other non-interest expense	**5,247**	3,700	**12,303**	9,701
Total non-interest expense	**17,102**	14,786	**46,978**	45,915
Income before income taxes	**2,943**	292	**7,941**	9,831
Federal income taxes	**668**	(37)	**2,100**	3,193
Net Income	**$ 2,275**	$ 329	**$ 5,841**	$ 6,638
Dividends accrued on preferred shares	**$ (463)**	$ (473)	**$ (1,388)**	$ (1,403)
Accretion on preferred shares	**$ (43)**	$ (40)	**$ (125)**	$ (118)
Net income (loss) applicable to common shares	**$ 1,769**	$ (184)	**$ 4,328**	$ 5,117
Earnings (loss) per common share (Note 7)				
Basic	**$ 0.22**	$ (0.02)	**$ 0.53**	$ 0.63
Diluted	**$ 0.22**	$ (0.02)	**$ 0.53**	$ 0.63
Dividends declared per share (Note 6)	**$**	$ 0.04	**$**	$ 0.295
Average shares outstanding (Note 7)				
Basic	**8,118**	8,117	**8,118**	8,117
Diluted	**8,118**	8,117	**8,143**	8,172

See accompanying notes

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FIRST DEFIANCE FINANCIAL CORP.

Consolidated Condensed Statements of Changes in Stockholders Equity

(UNAUDITED)

(Amounts in Thousands)

	Preferred Stock	Common Stock	Common Stock Warrant	Treasury Stock	Additional Paid-In Capital	Accumulated Other Comprehensive Income (Loss)	Retained Earnings	Total Stockholders Equity
Balance at January 1, 2010	$ 36,293	$ 127	$ 878	$ (72,631)	$ 140,677	$ (158)	$ 128,900	$ 234,086
Comprehensive income:								
Net income							5,841	5,841
Change in net unrealized gains and losses on available-for-sale securities, net of income taxes of $1,270						2,356		2,356
Total comprehensive income								8,197
Stock option expense					131			131
Stock options exercised				3				3
Preferred Stock Dividends							(1,388)	(1,388)
Accretion on preferred shares	125						(125)	
Balance at September 30, 2010	**$ 36,418**	**$ 127**	**$ 878**	**$ (72,628)**	**$ 140,808**	**$ 2,198**	**$ 133,228**	**$ 241,029**
Balance at January 1, 2009	$ 36,134	$ 127	$ 878	$ (72,638)	$ 140,447	$ (1,904)	$ 126,115	$ 229,159
Comprehensive income:								
Net income							6,638	6,638
Change in net unrealized gains and losses on available-for-sale securities, net of income taxes of $1,265						2,350		2,350
Total comprehensive income								8,988
Stock option expense					175			175
Stock options exercised				7			(2)	5
Preferred stock dividends							(1,403)	(1,403)
Accretion on preferred shares	118						(118)	
Common stock dividends declared							(2,395)	(2,395)
Balance at September 30, 2009	$ 36,252	$ 127	$ 878	$ (72,631)	$ 140,622	$ 446	$ 128,835	$ 234,529

See Accompanying Notes

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FIRST DEFIANCE FINANCIAL CORP.

Consolidated Condensed Statements of Cash Flows

(UNAUDITED)

(Amounts in Thousands)

	Nine Months Ended September 30, 2010	2009
Operating Activities		
Net income	**$ 5,841**	$ 6,638
Items not requiring (providing) cash		
Provision for loan losses	**17,525**	14,762
Depreciation	**2,543**	2,876
Amortization of mortgage servicing rights, net of impairment (recoveries)	**2,411**	1,708
Amortization of core deposit and other intangible assets	**1,139**	1,102
Net amortization of premiums and discounts on loans and deposits	**819**	582
Amortization of premiums and discounts on securities	**348**	(400)
Change in deferred taxes	**(2,845)**	(2,235)
Proceeds from the sale of loans held for sale	**229,192**	427,095
Originations of loans held for sale	**(236,939)**	(436,646)
Gain from sale of loans	**(5,359)**	(7,527)
OTTI losses on investment securities	**331**	2,262
Gain from sale or call of securities	**(6)**	
Loss on sale or write-down of real estate and other assets held for sale	**2,653**	1,226
Loss on sale of premises and equipment	**1**	6
Stock option expense	**131**	175
Income from bank owned life insurance	**(649)**	(338)
Gain on life insurance	**(268)**	
Changes in:		
Accrued interest receivable	**(397)**	(817)
Other assets	**(151)**	(1,468)
Other liabilities	**887**	(944)
Net cash provided by (used in) operating activities	**17,207**	8,057
Investing Activities		
Proceeds from maturities of held-to-maturity securities	**1,002**	89
Proceeds from maturities, calls and pay-downs of available-for-sale securities	**31,528**	18,036
Proceeds from sale of real estate and other assets held for sale	**8,311**	3,330
Proceeds from the sale of available-for-sale securities	**28**	6,383
Proceeds from sale of non-mortgage loans	**6,653**	6,103
Purchases of available-for-sale securities	**(47,501)**	(32,075)
Purchases of bank owned life insurance	**(1,758)**	(1,500)
Proceeds from bank owned life insurance	**728**	
Purchases of premises and equipment, net	**(1,223)**	(1,498)

Net cash paid for group benefits line of business	**(1,500)**	
Net decrease (increase) in loans receivable	**38,717**	(28,030)
Net cash provided by (used in) investing activities	**34,985**	(30,062)
Financing Activities		
Net increase in deposits and advance payments by borrowers	**10,317**	73,203
Repayment of Federal Home Loan Bank long-term advances	**(30,031)**	(30)
Net increase (decrease) in Federal Home Loan Bank short-term advances		(9,100)
Increase (decrease) in securities sold under repurchase agreements	**(6,475)**	(6,174)
Net change in secured borrowings	**2,928**	
Proceeds from the exercise of stock options	**3**	5
Cash dividends paid on common stock		(3,450)
Cash dividends paid on preferred stock	**(1,388)**	(1,285)
Net cash provided by (used in) financing activities	**(24,646)**	53,169
Increase (decrease) in cash and cash equivalents	**27,546**	31,164
Cash and cash equivalents at beginning of period	**121,116**	46,152
Cash and cash equivalents at end of period	**$ 148,662**	$ 77,316
Supplemental cash flow information:		
Interest paid	**$ 20,425**	$ 26,322
Income taxes paid	**$ 4,650**	$ 6,600
Transfers from loans to other real estate owned and other assets held for sale	**$ 10,086**	$ 6,908

See accompanying notes.

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FIRST DEFIANCE FINANCIAL CORP.

Notes to Consolidated Condensed Financial Statements

(Unaudited at September 30, 2010 and 2009)

1. Basis of Presentation

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

First Federal is primarily engaged in attracting deposits from the general public through its offices and using those and other available sources of funds to originate loans primarily in the counties in which its offices are located. First Federal s traditional banking activities include originating and servicing residential, commercial and consumer loans and providing a broad range of depository, trust and wealth management services. First Insurance is an insurance agency that does business in the Defiance, Archbold, Bryan, and Bowling Green, Ohio areas offering property and casualty, and group health and life insurance products. In May 2010, First Insurance acquired a group medical benefits business line from Andres O Neil & Lowe Insurance Agency.

The consolidated condensed statement of financial condition at December 31, 2009 has been derived from the audited financial statements at that date, which were included in First Defiance s Annual Report on Form 10-K.

The accompanying consolidated condensed financial statements as of September 30, 2010 and for the three and nine month periods ended September 30, 2010 and 2009 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 2009 Annual Report on Form 10-K for the year ended December 31, 2009. However, in the opinion of management, all adjustments, consisting of only normal recurring items, necessary for the fair presentation of the financial statements have been made. The results for the three and nine month periods ended September 30, 2010 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 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 net income applicable to common shares divided by the weighted average number of shares of common stock outstanding during the period. Diluted earnings per common share include the dilutive effect of additional potential common shares issuable under stock options, warrants and stock grants.

Reclassifications

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

Adoption of New Accounting Standards

In July 2010, the FASB issued ASU No. 2010-20, *Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*, which requires significant new disclosures about the allowance for credit losses and the credit quality of financing receivables. The requirements are intended to enhance transparency regarding credit losses and the credit quality of loan and lease receivables. Under this statement, allowance for credit losses and fair value are to be disclosed by portfolio segment, while credit quality information, impaired financing receivables and nonaccrual status are to be presented by class of financing receivable. Disclosure of the nature and extent, the financial impact and segment information of troubled debt restructurings will also be required. The disclosures are to be presented at the level of disaggregation that management uses when assessing and monitoring the portfolio s risk and performance. This ASU is effective for interim and annual reporting periods after December 15, 2010. The Company will include these disclosures in the notes to the December 31, 2010 financial statements.

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3. Comprehensive Income

Comprehensive income consists of net income and other comprehensive income (loss) (OCI). Other comprehensive income (loss) includes unrealized gains and losses on securities available-for-sale and the net unrecognized actuarial losses and unrecognized prior services costs associated with the Company s Defined Benefit Postretirement Medical Plan. All items reported in other comprehensive income (loss) are reported net of tax. Following is a summary of other comprehensive income (loss) for the three and nine months ended September 30, 2010 and 2009:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	**2009**	**2010**	**2009**
	(In thousands)			
Net income	**$ 2,275**	$ 329	**$ 5,841**	$ 6,638
Change in securities available-for-sale (AFS):				
Unrealized gains (losses) on securities AFS for which other-than-temporary impairment losses have been recognized in income	**(151)**	(350)	**(232)**	(1,864)
Other-than-temporary impairment losses on AFS realized in income	**190**	994	**331**	2,541
Net unrealized gains (losses)	**39**	664	**99**	677
Unrealized holding gains (losses) on securities AFS arising during the period	**1,097**	2,983	**3,533**	3,217
Reclassification adjustment for (gains) losses realized in income		(154)	**(6)**	(279)
Net unrealized gains (losses)	**1,097**	2,829	**3,527**	2,938
Income tax effect	**(397)**	(1,214)	**(1,270)**	(1,265)
Other comprehensive income (loss)	**738**	2,259	**2,356**	2,350
Comprehensive income	**$ 3,013**	$ 2,588	**$ 8,197**	$ 8,988

The following table summarizes the changes within each classification of accumulated other comprehensive income for the nine months ended September 30, 2010 and 2009:

	Unrealized gains (losses) on available for sale securities	Postretirement Benefit	Accumulated other comprehensive income (loss), net
		(In thousands)	
Balance at December 31, 2009	$ 468	$ (626)	$ (158)
Other comprehensive income (loss), net	2,356		2,356
Balance at September 30, 2010	$ 2,824	$ (626)	$ 2,198

	Unrealized gains (losses) on available for sale	Postretirement Benefit	Accumulated other comprehensive

	securities		income (loss), net
		(In thousands)	
Balance at December 31, 2008	$ (1,100)	$ (804)	$ (1,904)
Other comprehensive income (loss), net	2,350		2,350
Balance at September 30, 2009	$ 1,250	$ (804)	$ 446

4. 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.

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Available for sale securities - Securities classified as available for sale are generally reported at fair value utilizing Level 2 inputs where the Company obtains fair value measurements from an independent pricing service which uses matrix pricing, which is a mathematical technique widely used in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities relationship to other benchmark quoted securities (Level 2 inputs). The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows and the bonds terms and conditions, among other things. Securities in Level 1 include federal agency preferred stock securities. Securities in Level 2 include U.S. Government agencies, mortgage-backed securities 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 s valuations were supported by analysis prepared by an independent third party that is described further in Note 8.

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

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

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

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

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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

September 30, 2010	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
		(In Thousands)		
Available for sale securities:				
Obligations of U.S. Government corporations and agencies	$	$ 11,109	$	$ 11,109
Mortgage-backed residential		36,519		36,519
REMICs		3,598		3,598
Collateralized mortgage obligations		51,566		51,566
Trust preferred stock			1,432	1,432
Preferred stock	35			35
Obligations of state and political subdivisions		52,096		52,096
Mortgage banking derivative asset		1,376		1,376
Mortgage banking derivative liability		132		132

December 31, 2009	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
		(In Thousands)		
Available for sale securities:				
Obligations of U.S. Government corporations and agencies	$	$ 14,251	$	$ 14,251
Mortgage-backed residential		31,504		31,504
REMICs		3,923		3,923
Collateralized mortgage obligations		41,371		41,371
Trust preferred stock			1,589	1,589
Preferred stock	87			87
Obligations of state and political subdivisions		44,733		44,733
Mortgage banking derivative asset		380		380
Mortgage banking derivative liability				

The table below presents a reconciliation and income classification of gains and losses for all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the three and nine months ended September 30, 2010 and September 30, 2009:

	Fair Value Measurements Using Significant Unobservable Inputs (Level 3) (In Thousands)
Beginning balance, January 1, 2010	**$ 1,589**
Total gains or losses (realized/unrealized)	
Included in earnings	**(214)**
Included in other comprehensive income	**66**

(presented gross of taxes)		
Purchases, issuances, and settlements		**16**
Sales		**(25)**
Transfers in and/or out of Level 3		
Ending balance, September 30, 2010	**$**	**1,432**

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		Fair Value Measurements Using Significant Unobservable Inputs (Level 3) (In Thousands)
Beginning balance, July 1, 2010	$	1,516
Total gains or losses (realized/unrealized)		
Included in earnings		(73)
Included in other comprehensive income (presented gross of taxes)		(21)
Purchases, issuances, and settlements		10
Sales		
Transfers in and/or out of Level 3		
Ending balance, September 30, 2010	$	1,432

		Fair Value Measurements Using Significant Unobservable Inputs (Level 3) (In Thousands)
Beginning balance, January 1, 2009	$	3,873
Total gains or losses (realized/unrealized)		
Included in earnings		(2,541)
Included in other comprehensive income (presented gross of taxes)		547
Purchases, issuances, and settlements		(2)
Transfers in and/or out of Level 3		
Ending balance, September 30, 2009	$	1,877

		Fair Value Measurements Using Significant Unobservable Inputs (Level 3) (In Thousands)
Beginning balance, July 1, 2009	$	2,161
Total gains or losses (realized/unrealized)		
Included in earnings		(994)
Included in other comprehensive income (presented gross of taxes)		709
Purchases, issuances, and settlements		1
Transfers in and/or out of Level 3		
Ending balance, September 30, 2009	$	1,877

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

Assets and Liabilities Measured on a Non-Recurring Basis

September 30, 2010	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
		(In Thousands)		
Impaired loans	$	$	$ 30,133	$ 30,133
Mortgage servicing rights		8,289		8,289
Real estate held for sale			3,680	3,680

December 31, 2009	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
		(In Thousands)		
Impaired loans	$	$	$ 28,336	$ 28,336
Mortgage servicing rights		8,958		8,958
Real estate held for sale			935	935

Impaired loans, which are measured for impairment using the fair value of the collateral for collateral dependent loans, had a fair value of $30,133,000, with a valuation allowance of $16,613,000 at September 30, 2010. A provision expense of $3,947,000 and $13,414,000 for the three and nine months ended September 30, 2010 was included in earnings.

Mortgage servicing rights which are carried at lower of cost or fair value had a fair value of $8,289,000 at September 30, 2010, resulting in a valuation allowance of $2,255,000. A charge of $527,000 and $777,000 for the three and nine months ended September 30, 2010 was included in earnings.

Real estate held for sale is determined using Level 3 inputs which include appraisals and estimated costs to sell. The change in fair value of real estate held for sale was $1,614,000 and $2,643,000 for the three and nine months ended September 30, 2010 which was recorded directly as an adjustment to current earnings through non-interest expense.

In accordance with FASB ASC Topic 825, the table below is a comparative condensed consolidated statement of financial condition based on carrying amount and estimated fair values of financial instruments as of September 30, 2010 and December 31, 2009. 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.

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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.

Fair value for available for sale securities is as previously described. For investment securities held to maturity, fair has been based on current market quotations. If market prices are not available, fair value has been estimated based upon the quoted price of similar instruments.

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

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

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

The carrying value of subordinated debentures and deposits with fixed maturities is estimated based on interest rates currently being offered on instruments with similar characteristics and maturities. FHLB advances with maturities greater than 90 days are valued based on discounted cash flow analysis, using interest rates currently being quoted for similar characteristics and maturities. The cost or value of any call or put options is based on the estimated cost to settle the option at September 30, 2010.

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	September 30, 2010		December 31, 2009	
	Carrying Value	Estimated Fair Values	Carrying Value	Estimated Fair Values
		(In Thousands)		
Assets:				
Cash and cash equivalents	**$ 148,662**	**$ 148,662**	$ 121,116	$ 121,116
Investment securities	**157,273**	**157,302**	139,378	139,416
Federal Home Loan Bank Stock	**21,376**	**N/A**	21,376	N/A
Loans, net, including loans held for sale	**1,529,947**	**1,546,527**	1,590,921	1,586,101
Mortgage banking derivative asset	**1,376**	**1,376**	380	380
Accrued interest receivable	**7,248**	**7,248**	6,851	6,851
	1,865,882	**$ 1,861,115**	1,880,022	$ 1,853,864
Other assets	**176,357**		177,501	
Total assets	**$ 2,042,239**		$ 2,057,523	
Liabilities and stockholders equity:				
Deposits	**$ 1,590,648**	**$ 1,599,882**	$ 1,580,226	$ 1,586,466
Advances from Federal Home Loan Bank	**116,896**	**122,697**	146,927	152,643
Securities sold under repurchase agreements	**41,923**	**41,923**	48,398	48,398
Subordinated debentures	**36,083**	**34,399**	36,083	32,057
Mortgage banking derivative liability	**132**	**132**		
Accrued interest payable	**937**	**937**	1,234	1,234
Advance payments by borrowers for taxes and insurance	**501**	**501**	665	665
	1,787,120	**$ 1,800,471**	1,813,533	$ 1,821,463
Other liabilities	**14,090**		9,904	
Total liabilities	**1,801,210**		1,823,437	
Stockholders equity	**241,029**		234,086	
Total liabilities and stockholders equity	**$ 2,042,239**		$ 2,057,523	

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5. Stock Compensation Plans

First Defiance has established incentive stock option plans for its directors and employees. On March 15, 2010, the Board adopted, and the shareholders approved at the 2010 Annual Shareholders Meeting, the First Defiance Financial Corp. 2010 Equity Incentive Plan (the 2010 Equity Plan). The 2010 Equity Plan replaces all existing plans. All awards currently outstanding under the prior plans will remain in effect in accordance with their respective terms. Any new awards will be made under the 2010 Equity Plan. As of September 30, 2010, 423,750 options (401,750 for employees and 22,000 for directors) had been granted under prior option plans and remain outstanding at option prices based on the market value of the underlying shares on the date the options were granted. 5,000 options have been granted under the 2010 Equity Plan. Options granted under all plans vest 20% per year except for the options granted in 2009 to the Company s then five most-highly compensated employees, which options vest 40% in 2011 and then 20% annually, subject to certain other limitations. As of September 30, 2010, 300,370 of the outstanding options were currently exercisable. All options expire ten years from date of grant. Vested options of retirees expire on the earlier of the scheduled expiration date or three months after the retirement date.

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.

	Nine Months Ended September 30,	
	2010	**2009**
Expected average risk-free rate	**1.57%**	3.38%
Expected average life	**7.20 years**	6.41 years
Expected volatility	**44.62%**	26.10%
Expected dividend yield	**0.00%**	3.62%

The weighted-average fair value of options granted for the nine months ended September 30, 2010 and 2009 were $4.05 and $1.87, respectively.

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Following is activity under the prior option plans:

	Options Outstanding	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value
Options outstanding, beginning of period	**467,500**	**$ 19.41**		
Forfeited or cancelled	**(43,500)**	**20.71**		
Exercised	**(250)**	**9.22**		
Granted	**5,000**	**9.96**		
Options outstanding, end of period	**428,750**	**$ 19.18**	**5.0**	**$ 45**
Vested or expected to vest at period end	**428,750**	**$ 19.18**	**5.0**	**$ 45**
Exercisable at period end	**300,370**	**$ 20.54**	**3.8**	**$ 9**

Proceeds, related tax benefits realized from options exercised and intrinsic value of options exercised were as follows:

	Nine Months Ended September 30, 2010	2009
Cash received from option exercises	**$ 3,000**	$ 5,000
Tax benefit realized from option exercises		
Intrinsic value of options exercised	**1,000**	1,000

As of September 30, 2010, there was $286,000 of total unrecognized compensation costs related to unvested stock options granted under the Company s stock option plans. The cost is expected to be recognized over a weighted-average period of 2.56 years.

6. Dividends on Common Stock

No common stock dividends were declared by First Defiance in the first nine months of 2010. A quarterly cash dividend of $0.17, $0.085 and $0.04 per common share was declared for the first, second and third quarters of 2009, respectively.

As a result of its participation in the U.S. Treasury s Capital Purchase Program (CPP), First Defiance is prohibited without prior approval of the U.S. Treasury, from paying a quarterly cash dividend of more than $0.26 per share until the earlier of December 5, 2011 or the date the preferred stock issued to the U.S. Treasury by First Defiance is redeemed or transferred to an unaffiliated third party. Further, First Defiance has agreed with its primary regulator to obtain approval of cash dividends prior to declaration.

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7. Earnings Per Common Share

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

	Three months ended September 30,		Nine months ended September 30,	
	2010	**2009**	**2010**	**2009**
Numerator for basic and diluted earnings per common share Net income applicable to common shares	**$ 1,769**	$ (184)	**$ 4,328**	$ 5,117
Denominator:				
Denominator for basic earnings per common share weighted average common shares	**8,118**	8,117	**8,118**	8,117
Effect of warrants			**25**	54
Effect of employee stock options				1
Denominator for diluted earnings per common share	**8,118**	8,117	**8,143**	8,172
Basic earnings per common share	**$ 0.22**	$ (0.02)	**$ 0.53**	$ 0.63
Diluted earnings per common share	**$ 0.22**	$ (0.02)	**$ 0.53**	$ 0.63

There were 428,750 shares under option granted to employees excluded from the diluted earnings per common share calculation as they were anti-dilutive for the three and nine months ended September 30, 2010. There were 475,900 and 412,800 shares under option granted to employees excluded from the diluted earnings per common share calculation as they were anti-dilutive for the three and nine months ended September 30, 2009. Shares under option of 550,595 issuable related to warrants were excluded from the diluted earnings per common share calculations as they were anti-dilutive for the three months ended September 30, 2010 and 2009.

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8. Investment Securities

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

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
At September 30, 2010				
Available-for-Sale Securities:				
Obligations of U.S. government corporations and agencies	**$ 10,982**	**$ 127**	**$**	**$ 11,109**
Mortgage-backed securities residential	**34,955**	**1,564**		**36,519**
REMICs	**3,462**	**136**		**3,598**
Collateralized mortgage obligations	**49,553**	**2,032**	**(19)**	**51,566**
Trust preferred securities and preferred stock	**3,783**		**(2,316)**	**1,467**
Obligations of state and political subdivisions	**49,274**	**2,913**	**(91)**	**52,096**
Totals	**$ 152,009**	**$ 6,772**	**$ (2,426)**	**$ 156,355**
Held-to-Maturity Securities*:				
FHLMC certificates	**$ 98**	**$ 7**	**$**	**$ 105**
FNMA certificates	**271**	**7**		**278**
GNMA certificates	**90**	**3**		**93**
Obligations of state and political subdivisions	**459**	**12**		**471**
Totals	**$ 918**	**$ 29**	**$**	**$ 947**
At December 31, 2009				
Available-for-Sale Securities:				
Obligations of U.S. government corporations and agencies	$ 14,038	$ 252	$ (39)	$ 14,251
Mortgage-backed securities residential	30,341	1,194	(31)	31,504
REMICs	3,718	205		3,923
Collateralized mortgage obligations	40,878	824	(331)	41,371
Trust preferred securities and preferred stock	4,122		(2,446)	1,676
Obligations of state and political subdivisions	43,640	1,251	(158)	44,733
Totals	$ 136,737	$ 3,726	$ (3,005)	$ 137,458
Held-to-Maturity Securities*:				
FHLMC certificates	$ 119	$ 7	$	$ 126
FNMA certificates	304	9		313
GNMA certificates	107	3		110
Obligations of state and political subdivisions	1,390	19		1,409
Totals	$ 1,920	$ 38	$	$ 1,958

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

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The amortized cost and fair value of securities at September 30, 2010 by contractual maturity are shown below. 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 real estate mortgage investment conduits (REMICs), which are not due at a single maturity date, have not been allocated over the maturity groupings. The MBS, CMO and REMIC 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	**$ 3,068**	**$ 3,045**	**$ 60**	**$ 60**
Due after one year through five years	**4,255**	**4,436**	**120**	**132**
Due after five years through ten years	**10,383**	**10,938**	**279**	**279**
Due after ten years	**46,333**	**46,253**		
MBS/CMO/REMIC	**87,970**	**91,683**	**459**	**476**
	$ 152,009	**$ 156,355**	**$ 918**	**$ 947**

Investment securities with a carrying amount of $119.2 million at September 30, 2010 were pledged as collateral on public deposits, securities sold under repurchase agreements and FHLB advances.

As of September 30, 2010, the Company s investment portfolio consisted of 307 securities, 16 of which were in an unrealized loss position.

The following table summarizes First Defiance s securities that were in an unrealized loss position at September 30, 2010:

	Duration of Unrealized Loss Position					
	Less than 12 Months		12 Month or Longer		Total	
	Fair Value	Gross Unrealized Loss	Fair Value	Gross Unrealized Loss	Fair Value	Unrealized Losses
			(In Thousands)			
At September 30, 2010						
Available-for-sale securities:						
Collateralized mortgage obligations and REMICs	**$**	**$**	**$ 466**	**$ (19)**	**$ 466**	**$ (19)**
Trust preferred stock and preferred stock			**1,432**	**(2,316)**	**1,432**	**(2,316)**
Obligations of state and political subdivisions	**875**	**(44)**	**1,207**	**(47)**	**2,082**	**(91)**
Total temporarily impaired securities	**$ 875**	**$ (44)**	**$ 3,105**	**$ (2,382)**	**$ 3,980**	**$ (2,426)**

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.

Management evaluates securities for other-than-temporary impairment (OTTI) at least on a quarterly basis, 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 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.

Management s analysis for the third quarter of 2010 deemed that OTTI write-downs were necessary on two CDOs resulting in OTTI write-downs of $73,000 compared to $994,000 for the same period in 2009. Also in the third quarter of 2010, $117,000 of OTTI was recognized relating to the write-down of the preferred stock issued by Fannie Mae and Freddie Mac. These investments were written down to fair value of $17,500 (Fannie Mae) and $17,200 (Freddie Mac). For the first nine months of 2010, the Company has recorded OTTI write-downs of $331,000 compared to $2.5 million for the same period in 2009.

The Company held nine collateralized debt obligations (CDOs) at September 30, 2010. Four of those CDOs were written down in full prior to January 1, 2010. The remaining five CDOs have a total amortized cost of $3.7 million at September 30, 2010. Of these, three, with a total amortized cost of $1.8 million, were identified as OTTI in prior periods. The final two CDOs, with a total amortized cost of $2.0 million, continue to pay principal and interest payments in accordance with the contractual terms of the securities and no credit loss impairment has been identified in management s analysis. Therefore, these two CDO investments have not been deemed by management to be OTTI. The Company held three additional CDOs at December 31, 2009 with a total amortized cost of $25,000. These CDOs were classified as held for sale at December 31, 2009 and were sold during the first quarter of 2010.

As required under FASB ASC Topic 320, beginning January 1, 2009, 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.

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

The Company s CDO valuations were supported by analysis prepared by an independent third party and supported by management s analyses. 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.

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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 seven securities with other-than-temporary impairment, their lowest credit rating at September 30, 2010 and the related credit losses recognized in earnings for the three month periods ended March 31, 2010, June 30, 2010 and September 30, 2010 (In Thousands):

	Preferred Term VI	TPREF Funding II	Alesco VIII	Preferred Term Security XXVII	Trapeza CDO I	Alesco Preferred Funding VIII	Alesco Preferred Funding IX	
	Rated Caa1	**Rated Caa3**	**Rated Ca**	**Rated Ca**	**Rated Ca**	**Not Rated**	**Not Rated**	**Total**
Cumulative OTTI related to credit loss at January 1, 2010	$ 17	$ 243	$ 1,000	$	$ 857	$ 453	$ 465	$ 3,035
Addition Qtr 1	48			22				70
Cumulative OTTI related to credit loss at March 31, 2010	$ 65	$ 243	$ 1,000	$ 22	$ 857	$ 453	$ 465	$ 3,105
Addition Qtr 2		17		54				71
Cumulative OTTI related to credit loss at June 30, 2010	$ 65	$ 260	$ 1,000	$ 76	$ 857	$ 453	$ 465	$ 3,176
Addition Qtr 3	15	58						73
Cumulative OTTI related to credit loss at September 30, 2010	$ 80	$ 318	$ 1,000	$ 76	$ 857	$ 453	$ 465	$ 3,249

In addition to the table above and below, $117,000 of OTTI was recognized relating to the write-down of the preferred stock issued by Fannie Mae and Freddie Mac in the third quarter of 2010.

The following table provides additional information related to the five CDO investments for which a balance remains as of September 30, 2010 (dollars in thousands):

CDO	Class	Amortized Cost	Fair Value	Unrealized Loss	OTTI Losses 2010	Lowest Rating	Current Number of Banks and Insurance Companies	Actual Deferrals and Defaults as a % of Current Collateral	Expected Deferrals and Defaults as a % of Remaining Performing Collateral	Excess Sub-ordination as a % of Current Performing Collateral
Preferred Term VI	Mezz	$ 183	$ 84	$ (99)	$ (63)	Caa1	5	71.33%	%	%
TPREF Funding II	B	677	262	(415)	(75)	Caa3	18	37.37%	26.28%	
I-Preferred Term Sec I	B-1	1,000	482	(518)		CCC	16	9.04%	19.13%	13.92%
Dekania II CDO	C-1	989	453	(536)		CCC	36		15.01%	28.80%
Preferred Term Sec XXVII	C-1	899	151	(748)	(76)	Ca	33	29.37%	26.18%	0.52%
Total		$ 3,748	$ 1,432	$ (2,316)	$ (214)					

The increase in OTTI in the third quarter of 2010 was the result of deterioration in the performance of the underlying collateral. Specifically, depreciation was driven by both realized credit events (i.e. defaults and deferrals) and weakening credit fundamentals in some of the performing collateral, which led to an increased probability of default going forward. Excluding Preferred Term VI, the Company s assumed average lifetime default rate on the securities in the above table, declined from 29.9% at the end of the second quarter 2010 to a rate of 29.8% at the end of the third quarter 2010.

The table below presents a roll-forward of the credit losses relating to debt securities recognized in earnings for the nine months ended September 30, 2010 (in thousands):

Beginning balance, January 1, 2010	$ 2,521
Additions for amounts related to credit loss for which an OTTI was not previously recognized	76
Reductions for amounts realized for securities sold during the period	(2,261)
Reductions for amounts related to securities for which the Company intends to sell or that it will be more likely than not that the company will be required to sell prior to recovery of amortized cost basis	
Reductions for increase in cash flows expected to be collected that are recognized over the remaining life of the security	
Increases to the amount related to the credit loss for which other-than-temporary was previously recognized	138
Ending balance, September 30, 2010	$ 474

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Sales and write-downs of available for sale securities were as follows:

	Three Months Ended September 30, 2010	Three Months Ended September 30, 2009	Nine Months Ended September 30, 2010	Nine Months Ended September 30, 2009
	(In thousands)		(In thousands)	
Proceeds	$	$ 2,779	$ 28	$ 6,383
Gross realized gains		154	3	279
Gross realized losses				

The Company also recognized gross gains of $3,000 and $0 on calls during the first nine months ended September 30, 2010 and 2009, respectively.

9. Loans

Loans receivable consist of the following (in thousands):

	September 30, 2010	December 31, 2009
Real Estate:		
Secured by single family residential	**$ 213,574**	$ 227,592
Secured by multi-family residential	**100,576**	103,169
Secured by non-residential real estate	**676,396**	703,721
Construction	**31,722**	48,625
	1,022,268	1,083,107
Other Loans:		
Commercial	**372,583**	379,408
Automobile	**17,188**	21,661
Home equity and improvement	**137,747**	147,977
Other	**9,872**	12,444
	537,390	561,490
Total loans	**1,559,658**	1,644,597
Deduct:		
Undisbursed loan funds	**(9,030)**	(26,494)
Net deferred loan origination fees and costs	**(951)**	(981)
Allowance for loan loss	**(41,343)**	(36,547)
Totals	**$ 1,508,334**	$ 1,580,575

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Changes in the allowance for loan losses were as follows (in thousands):

	Three Months ended September 30,		Nine Months ended September 30,	
	2010	**2009**	**2010**	**2009**
Balance at beginning of period	**$ 38,852**	$ 25,840	**$ 36,547**	$ 24,592
Provision for loan losses	**5,196**	8,051	**17,525**	14,762
Charge-offs:				
Residential	**1,164**	744	**2,625**	1,397
Commercial real estate	**688**	1,152	**5,122**	3,887
Commercial	**842**	658	**4,730**	2,310
Home equity and improvement	**148**	196	**703**	627
Consumer finance	**28**	39	**69**	245
Total charge-offs	**2,870**	2,789	**13,249**	8,466
Recoveries	**165**	146	**520**	360
Net charge-offs	**2,705**	2,643	**12,729**	8,106
Ending allowance	**$ 41,343**	$ 31,248	**$ 41,343**	$ 31,248

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

	September 30, 2010	December 31, 2009
	(in thousands)	
Non-accrual loans	**$ 37,377**	$ 41,191
Loans over 90 days past due and still accruing		
Troubled debt restructuring, still accruing	**8,784**	6,715
Total non-performing loans	**46,161**	$ 47,906
Real estate and other assets held for sale	**11,127**	13,527
Total non-performing assets	**$ 57,288**	$ 61,433

Impaired loans were as follows as of September 30, 2010 (in thousands):

Period-end impaired loans with no allowance for loan losses allocated	**$ 20,213**
Period-end impaired loans with allowance for loan losses allocated	**46,745**
Total	**$ 66,958**
Amount of the allowance allocated to impaired loans	**$ 16,613**

Impaired loans were as follows as of December 31, 2009 (in thousands):

Period-end impaired loans with no allowance for loan losses allocated	$ 18,239
Period-end impaired loans with allowance for loan losses allocated	40,585
Total	$ 58,824
Amount of the allowance allocated to impaired loans	$ 12,249

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	Three Months Ended Sept 30, 2010	Three Months Ended Sept 30, 2009	Nine Months Ended Sept 30, 2010	Nine Months Ended Sept 30, 2009
	(in thousands)			
Average of impaired loans during the period	**$ 63,677**	$ 39,945	**$ 62,802**	$ 33,869
Interest income recognized during the period	**596**	219	**1,458**	549
Cash-basis interest income recognized	**578**	219	**1,288**	518

The Company has no outstanding commitments to lend additional funds to borrowers whose loans have been modified in a troubled debt restructuring.

10. Mortgage Banking

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

	Three Months Ended Sept 30, 2010	Three Months Ended Sept 30, 2009	Nine Months Ended Sept 30, 2010	Nine Months Ended Sept 30, 2009
	(in thousands)			
Gain from sale of mortgage loans	**$ 2,886**	$ 1,541	**$ 5,262**	$ 7,276
Mortgage loans servicing revenue (expense):				
Mortgage loans servicing revenue	**761**	725	**2,263**	2,109
Amortization of mortgage servicing rights	**(798)**	(514)	**(1,634)**	(2,625)
Mortgage servicing rights valuation adjustments	**(527)**	(772)	**(777)**	917
	(564)	(561)	**(148)**	401
Net revenue from sale and servicing of mortgage loans	**$ 2,322**	$ 980	**$ 5,114**	$ 7,677

The unpaid principal balance of residential mortgage loans serviced for third parties was $1.2 billion at September 30, 2010 and September 30, 2009.

Activity for capitalized mortgage servicing rights and the related valuation allowance follows for the three and nine months ended September 30, 2010 and 2009:

	Three Months Ended Sept 30, 2010	Three Months Ended Sept 30, 2009	Nine Months Ended Sept 30, 2010	Nine Months Ended Sept 30, 2009
	(in thousands)			
Mortgage servicing assets:				
Balance at beginning of period	**$ 10,448**	$ 10,022	**$ 10,436**	$ 9,403
Loans sold, servicing retained	**894**	717	**1,742**	3,447
Amortization	**(798)**	(514)	**(1,634)**	(2,625)
Carrying value before valuation allowance at end of period	**10,544**	10,225	**10,544**	10,225
Valuation allowance:				
Balance at beginning of period	**(1,728)**	(1,103)	**(1,478)**	(2,792)
Impairment recovery (charges)	**(527)**	(772)	**(777)**	917
Balance at end of period	**(2,255)**	(1,875)	**(2,255)**	(1,875)

Net carrying value of MSRs at end of period	**$ 8,289**	$ 8,350	**$ 8,289**	$ 8,350
Fair value of MSRs at end of period	**$ 8,289**	$ 8,350	**$ 8,289**	$ 8,350

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

11. Deposits

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

	September 30, 2010	December 31, 2009
Non-interest-bearing checking accounts	**$ 213,414**	$ 189,132
Interest-bearing checking and money market accounts	**543,539**	499,575
Savings accounts	**141,190**	130,156
Retail certificates of deposit less than $100,000	**485,777**	550,710
Retail certificates of deposit greater than $100,000	**161,413**	163,300
Brokered or national certificates of deposit	**45,315**	47,353
	$ 1,590,648	$ 1,580,226

12. Borrowings

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

	September 30, 2010	December 31, 2009
	(in thousands)	
FHLB Advances:		
Overnight borrowings	**$**	$
Single maturity fixed rate advances	**35,000**	35,000
Single maturity LIBOR based advances		20,000
Putable advances	**54,000**	64,000
Strike-rate advances	**27,000**	27,000
Amortizable mortgage advances	**896**	927
Total	**$ 116,896**	$ 146,927
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. As of September 30, 2010, $14.0 million of the putable advances with a weighted average rate of 2.69% are not yet callable by the FHLB, but on October 14, 2010, $5.0 million became callable. The call dates for these advances range from October 14, 2010 to February 11, 2011 and the maturity dates range from February 11, 2013 to March 12, 2018. The FHLB has the option to call the remaining $40.0 million of putable advances with a weighted average rate of 4.80%. The maturity dates of these advances range from February 2, 2011 to January 14, 2015. The strike-rate advances are putable at the option of the FHLB only when the three month LIBOR rates exceed the agreed upon strike-rate in the advance contract which ranges from 7.5% to 8.0%. The three month LIBOR rate at September 30, 2010 was 0.29%. The weighted average rate of the strike-rate advances is 4.18% and the maturity dates range from March 8, 2011 to February 25, 2013.

In March 2007, the Company sponsored an affiliated trust, First Defiance Statutory Trust II (Trust Affiliate II) that issued $15 million of Guaranteed Capital Trust Securities (Trust Preferred Securities). In connection with this transaction, the Company issued $15.5 million of Junior Subordinated Deferrable Interest Debentures (Subordinated Debentures) to Trust Affiliate II. The Company formed Trust Affiliate II for the purpose of issuing Trust Preferred Securities to third-party investors and investing the proceeds from the sale of these capital securities solely in Subordinated Debentures of the Company. The Subordinated Debentures held by Trust Affiliate II are the sole assets of that trust. The Company is not considered the primary beneficiary of this Trust (variable interest entity), therefore the trust is not consolidated in the Company s financial statements, but rather the subordinated debentures are shown as a liability. Distributions on the Trust Preferred Securities issued by Trust Affiliate II are payable quarterly at a fixed rate equal to 6.441% for the first five years and a floating interest rate based on three-month LIBOR plus 1.50% points, repricing quarterly, thereafter.

The 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 1.67% and 1.63% on September 30, 2010 and December 31, 2009 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.

13. 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.

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

The Company s maximum obligation to extend credit for loan commitments (unfunded loans and unused lines of credit) and standby letters of credit outstanding as of the periods stated below were as follows (in thousands):

	September 30, 2010		December 31, 2009	
	Fixed Rate	**Variable Rate**	**Fixed Rate**	**Variable Rate**
Commitments to make loans	**$ 37,618**	**$ 57,676**	$ 29,206	$ 64,243
Unused lines of credit	**30,816**	**193,569**	36,772	195,692
Standby letters of credit	**283**	**31,524**	263	21,036
Total	**$ 68,717**	**$ 282,769**	$ 66,241	$ 280,971

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 $92.3 million and $23.8 million of loans to Freddie Mac, Fannie Mae, Federal Home Loan Bank of Cincinnati or BB&T Mortgage at September 30, 2010 and December 31, 2009, respectively.

14. 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 2006. The Company currently operates primarily in the states of Ohio and Michigan, which tax financial institutions based on their equity rather than their income.

15. 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 as hedge relationships. First Federal had approximately $16.7 million and $18.7 million of interest rate lock commitments at September 30, 2010 and December 31, 2009, respectively. There were $75.7 million and $23.8 million of forward commitments for the future delivery of residential mortgage loans at September 30, 2010 and December 31, 2009, respectively.

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

	September 30, 2010 Assets	(Liabilities)		December 31, 2009 Assets	(Liabilities)	
	Carrying Value	Carrying Value	Derivative Net Carrying Value	Carrying Value	Carrying Value	Derivative Net Carrying Value
	(In Thousands)					
Derivatives not designated as hedging instruments						
Mortgage Banking Derivatives	**$ 1,376**	**$ (132)**	**$ 1,244**	$ 380	$	$ 380

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 Sept 30, 2010	2009	Nine Months Ended Sept 30, 2010	2009
	(in thousands)			
Derivatives designated as hedging instruments				
Mortgage Banking Derivatives Gain (Loss)	**$ 760**	$ 37	**$ 864**	$ (522)

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

16. Acquisition

On May 20, 2010, First Defiance acquired a group medical benefits line of business from Andres O Neil & Lowe Insurance Agency (AOL) for a cash purchase price of $1.5 million and future consideration to be paid in cash in 2010, 2011 and 2012. As of September 30, 2010, management has determined goodwill of $971,200 and identifiable intangible assets of $735,800 consisting of customer relationship intangible of $597,800 and a non-compete intangible of $138,000. Disclosure of pro forma results of this acquisition is not material to the Company s consolidated financial statements.

17. Group Life Plan

On June 30, 2010, First Federal adopted the First Federal Bank of the Midwest Executive Group Life Plan Post Separation (the Plan) in which various employees, including the Company s named executive offices, may participate.

Under the terms of the Plan, First Federal will purchase and own life insurance policies covering the lives of employees selected by the board of directors of First Federal as participants.

There was no expense required to be recorded as of June 30, 2010. There was $273,278 recorded in the third quarter of 2010 and $273,278 will be recorded and expensed during the fourth quarter.

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

General - First Defiance Financial Corp. (First Defiance or the Company) is a unitary thrift holding company that conducts business through its two wholly owned subsidiaries, First Federal Bank of the Midwest (First Federal) and First Insurance and Investments, Inc. (First Insurance). First Federal is a federally chartered savings bank that provides financial services through 33 full-service branches 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 services. First Insurance sells a variety of property and casualty, group health and life, and individual health and life insurance products and investment and annuity products. Insurance products are sold through First Insurance s offices in Defiance, Archbold, Bryan, and Bowling Green, Ohio while investment and annuity products are sold through registered investment representatives located at certain First Federal banking center locations.

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. Management remains concerned about increases in interest rates, inflation, and the unintended consequences of increased government intervention. During 2010, management continues 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 this need of its clients. First Federal believes this personal service model differentiates First Federal from its competitors, particularly the larger regional institutions. First Federal offers a wide variety of products to support commercial clients including remote deposit capture and other cash management services. First Federal also believes that the small business customer is a strong market for First Federal. First Federal participates in many of the Small Business Administration lending programs. Maintaining a diversified portfolio with an emphasis on monitoring industry concentrations and reacting to changes in the credit characteristics of industries is an ongoing focus.

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

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

Deposit Growth - First Federal s focus has been to grow core deposits with an emphasis on total relationship banking with both its 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 compliment its overall market share and compliment its strategy of being a high performing community bank.

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

Expansion Opportunities - First Defiance believes it is well positioned to take advantage of acquisitions or other business opportunities in its market areas, including FDIC-assisted transactions. First Defiance believes it has a track record of successfully accomplishing both acquisitions and de novo branching in its market area. This track record puts the Company in a solid position to enter or expand its business. First Defiance has successfully integrated acquired institutions in the past with the most recent bank 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. In May 2010, First Insurance acquired a group benefits business line from Andres O Neil & Lowe Insurance Agency.

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 $918,000 at September 30, 2010. 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 $156.4 million at September 30, 2010. The available-for-sale portfolio consists of obligations of U.S. Government corporations and agencies ($11.1 million), certain municipal obligations ($52.1 million), CMOs and REMICs ($55.2 million), mortgage backed securities ($36.5 million) and trust preferred and preferred stock ($1.5 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 new money is extended. The appraisal process is handled by First Federal s Credit Department, which selects the appraiser and orders the appraisal. First Federal 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 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. Finally, First Federal assesses whether there is any collateral short fall, considering guarantor support, and determines if a reserve is necessary.

When a collateral dependent loan moves to non-performing status, First Federal generally gets a new third party appraisal and adjusts the reserve as necessary based upon the new appraisal and an estimate of costs to liquidate the collateral. All properties that are moved into the other real estate owned (OREO) category are supported by current appraisals, and the OREO is carried at the appraised value less First Federal s estimate of the liquidation costs.

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

All collateral dependent loans over 90 days past due and or on non-accrual status as well as all troubled debt restructured collateral dependent loans are classified as non-performing loans. Non-performing status automatically occurs in the month in which the 90 day delinquency occurs. For troubled debt restructured collateral dependent loans, the loans are put into non-performing status in the month in which the restructure occurs.

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

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

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

For loans where First Federal determines that an updated appraisal is not necessary, other means are used to verify the value of the real state, such as recent sales of similar properties on which First Federal had loans as well as calls to appraisers, brokers, realtors, and investors. First Federal monitors and tracks its reserves quarterly to determine accuracy. Based on these results, changes may occur in specific reserves assigned. A recent analysis indicates that First Federal is within its target range of the ultimate losses on liquidated loans being on average within 10% of the specific reserves established for these loans.

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

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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.

Impact of Recent and Future Legislation

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act), which significantly changes the regulation of financial institutions and the financial services industry. The Dodd-Frank Act includes provisions affecting large and small financial institutions alike, including several provisions that will profoundly affect how community banks, thrifts, and small bank and thrift holding companies, such as First Defiance, will be regulated in the future. Among other things, these provisions abolish the Office of Thrift Supervision and transfer its functions to other federal banking agencies, relax rules regarding interstate branching, allow financial institutions to pay interest on business checking accounts, change the scope of federal deposit insurance coverage, and impose new capital requirements on bank and thrift holding companies. The Dodd-Frank Act also establishes the Bureau of Consumer Financial Protection as an independent entity within the Federal Reserve, which will be given the authority to promulgate consumer protection regulations applicable to all entities offering consumer financial services. Additionally, the Dodd-Frank Act includes a series of provisions covering mortgage loan origination standards, affecting, among other things, originator compensation, minimum repayment standards, and pre-payments. The Dodd-Frank Act contains numerous other provisions affecting financial institutions of all types, many of which may have an impact on the operating environment of First Defiance in substantial and unpredictable ways. Consequently, the Dodd-Frank Act is likely to affect First Defiance s cost of doing business, it may limit or expand the Company s permissible activities, and it may affect the competitive balance within the financial services industry and the Company s market area. The nature and extent of future legislative and regulatory changes affecting financial institutions, including as a result of the Dodd-Frank Act, is very unpredictable at this time. First Defiance s management team is actively reviewing the provisions of the Dodd-Frank Act, many of which are phased-in over the next several months and years, and assessing its probable impact on the business, financial condition, and results of operations of the Company. However, the ultimate effect of the Dodd-Frank Act on the financial services industry in general, and First Defiance in particular, is uncertain at this time.

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Participation in the U.S. Treasury Capital Purchase Program

On October 14, 2008, the Capital Purchase Program (CPP) was announced by the U.S. Treasury as part of the Troubled Asset Relief Program (TARP). The purpose of the CPP was to encourage U.S. financial institutions to build capital to increase the flow of financing to U.S. businesses and consumers and to support the U.S. economy. Institution s participating in the CPP are required to comply with a number of restrictions and provisions, including standards for executive compensation and corporate governance and limitations on share repurchases and the declaration and payment of dividends on common shares. The standard terms of the CPP require that a participating financial institution limit the payment of dividends to the most recent quarterly amount prior to October 14, 2008, which is $0.26 per share in the case of First Defiance. This dividend limitation remains in effect until the preferred shares issued to the U.S. Treasury are no longer outstanding.

First Defiance applied and was approved to participate in the CPP. As a result, on December 5, 2008, First Defiance issued $37.0 million of cumulative perpetual preferred shares, with a liquidation preference of $1,000 per share (Senior Preferred Shares) to the U.S. Treasury. The Senior Preferred Shares constitute Tier 1 capital and rank senior to First Defiance s common shares. The Senior Preferred Shares pay cumulative dividends at a rate of 5% per annum for the first five years and will reset to a rate of 9% per annum after five years.

As part of its participation in the CPP, First Defiance also issued a warrant to the U.S. Treasury to purchase 550,595 common shares having an exercise price of $10.08 per share. The initial exercise price for the warrant and the market price for determining the number of common shares subject to the warrant were determined by reference to the market price of the common shares on the date of the investment by the U.S. Treasury in the Senior Preferred Shares (calculated on a 20-day trailing average). The warrant has a term of 10 years.

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 thereo comparable terminology are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21B of the Securities Act of 1934, as amended. Actual results could differ materially from those indicated in such statements due to risks, uncertainties and changes with respect to a variety of market and other factors.

Changes in Financial Condition

At September 30, 2010, First Defiance s total assets, deposits and stockholders equity amounted to $2.04 billion, $1.59 billion and $241.0 million, respectively, compared to $2.06 billion, $1.58 billion and $234.1 million, respectively, at December 31, 2009.

Net loans receivable (excluding loans held for sale) declined $72.2 million to $1.51 billion from $1.58 billion at December 31, 2009. The decrease in loans is mainly attributable to the continued economic weakness in the market areas served by the Company. The Company is starting to see some signs of improvement as some businesses are showing stronger 2010 operating results and improved cash flows but the signs are more isolated than across the board. The variances in loans receivable between September 30, 2010 and December 31, 2009 include decreases in commercial real estate loans (down $29.9 million), commercial loans (down $6.8 million), home equity and improvement loans (down $10.2 million), construction loans (down $16.9 million), consumer loans (down $7.0 million) and one to four family residential real estate (down $14.0 million).

The investment securities portfolio increased $17.9 million to $157.3 million at September 30, 2010 from $139.4 million at December 31, 2009. The increase is the result of $47.5 million of securities being purchased during the first nine months of 2010 partially offset by $19.2 million of securities being matured or called in the period, principal pay downs of $13.3 million in CMOs and mortgage-backed securities, and $22,000 of securities being sold. There was an unrealized gain in the investment portfolio of $4.3 million at September 30, 2010 compared to an unrealized gain of $721,000 at December 31, 2009.

Deposits increased $10.4 million to $1.59 billion at September 30, 2010 compared to December 31, 2009. Interest-bearing demand deposits and money market accounts increased $44.0 million to $543.5 million, savings accounts increased $11.0 million to $141.2 million and non interest-bearing demand deposits increased $24.3 million to $213.4 million. These increases were mostly offset by a decline in retail time deposits of $66.8 million to $647.2 million.

FHLB advances decreased $30.0 million to $116.9 million at September 30, 2010 from $146.9 million at December 31, 2009. The decrease is the result of paying off a $10.0 million putable advance in the third quarter of 2010 and a $20.0 million LIBOR advance in the first quarter of 2010.

Stockholders equity increased from $234.1 million at December 31, 2009 to $241.0 million at September 30, 2010. The increase is primarily the result of recording net income of $5.8 million and a $2.4 million increase in the unrealized gain on available-for-sale securities, net of tax, partially offset by $1.4 million of accrued dividends on preferred stock.

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

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

	Three Months Ended September 30,					
	2010			2009		
	Average Balance	Interest(1)	Yield/ Rate(2)	Average Balance	Interest(1)	Yield/ Rate(2)
Interest-earning assets:						
Loans receivable	$ 1,545,378	$ 22,266	5.72%	$ 1,613,529	$ 23,812	5.85%
Securities	159,045	1,814	4.64	130,673	1,685	5.08
Interest-earning deposits	98,112	68	0.27	60,822	41	0.27
FHLB stock and other	21,376	225	4.18	21,376	258	4.79
Total interest-earning assets	1,823,911	24,373	5.31	1,826,400	25,796	5.60
Non-interest-earning assets	221,924			203,570		
Total assets	$ 2,045,835			$ 2,029,970		
Interest-bearing liabilities:						
Deposits	$ 1,385,093	$ 4,667	1.34%	$ 1,374,441	$ 6,163	1.78%
FHLB advances	123,566	1,187	3.81	146,941	1,267	3.42
Subordinated debentures	36,229	332	3.64	36,228	344	3.77
Notes payable	44,927	109	0.96	44,685	140	1.24
Total interest-bearing liabilities	1,589,815	6,295	1.57	1,602,295	7,914	1.96
Non-interest bearing deposits	200,207			175,928		
Total including non-interest bearing demand deposits	1,790,022	6,295	1.40	1,778,223	7,914	1.77
Other non-interest-bearing liabilities	15,104			17,506		
Total liabilities	1,805,126			1,795,729		
Stockholders equity	240,709			234,241		
Total liabilities and stock- holders equity	$ 2,045,835			$ 2,029,970		
Net interest income; interest rate spread		$ 18,078	3.74%		$ 17,882	3.64%
Net interest margin (3)			3.94%			3.88%
Average interest-earning assets to average interest-bearing liabilities			115%			114%

(1) Interest on certain tax-exempt loans and securities is not taxable for Federal income tax purposes. In order to compare the tax-exempt yields on these assets to taxable yields, the interest earned on these assets is adjusted to a pre-tax equivalent amount based on the marginal

corporate federal income tax rate of 35%.

(2) Annualized

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

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	Nine Months Ended September 30,					
	2010			2009		
	Average Balance	Interest(1)	Yield/ Rate(2)	Average Balance	Interest(1)	Yield/ Rate(2)
Interest-earning assets:						
Loans receivable	$ 1,552,393	$ 67,216	5.79%	$ 1,600,878	$ 70,333	5.87%
Securities	152,318	5,364	4.79	126,883	5,145	5.36
Interest-earning deposits	107,608	198	0.25	63,093	89	0.19
FHLB stock and other	21,376	678	4.24	21,376	726	4.54
Total interest-earning assets	1,833,695	73,456	5.36	1,812,230	76,293	5.61
Non-interest-earning assets	218,060			202,008		
Total assets	$ 2,051,755			$ 2,014,238		
Interest-bearing liabilities:						
Deposits	$ 1,393,747	$ 15,192	1.46%	$ 1,366,645	$ 20,206	1.98%
FHLB advances	130,745	3,625	3.71	146,994	3,865	3.52
Subordinated debentures	36,229	982	3.62	36,241	1,139	4.20
Notes payable	45,731	329	0.96	42,446	433	1.36
Total interest-bearing liabilities	1,606,452	20,128	1.67	1,592,326	25,643	2.15
Non-interest bearing deposits	192,673			172,341		
Total including non-interest bearing demand deposits	1,799,125	20,128	1.50	1,764,667	25,643	1.94
Other non-interest-bearing liabilities	14,871			17,659		
Total liabilities	1,813,996			1,782,326		
Stockholders equity	237,759			231,912		
Total liabilities and stock- holders equity	$ 2,051,755			$ 2,014,238		
Net interest income; interest rate spread		$ 53,328	3.69%		$ 50,650	3.46%
Net interest margin (3)			3.89%			3.73%
Average interest-earning assets to average interest-bearing liabilities			114%			114%

(1) Interest on certain tax-exempt loans and securities is not taxable for Federal income tax purposes. In order to compare the tax-exempt yields on these assets to taxable yields, the interest earned on these assets is adjusted to a pre-tax equivalent amount based on the marginal corporate federal income tax rate of 35%.

(2) Annualized

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

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Results of Operations

Three Months Ended September 30, 2010 and 2009

On a consolidated basis, First Defiance s net income for the quarter ended September 30, 2010 was $2.3 million compared to net income of $329,000 for the comparable period in 2009. Net income applicable to common shares was $1.8 million for the third quarter of 2010 compared to a loss of $184,000 for the comparable period in 2009. On a per share basis, basic and diluted earnings per common share for the three months ended September 30, 2010 were both $0.22, compared to basic and diluted earnings per common share of $(0.02) for the quarter ended September 30, 2009.

Net Interest Income.

First Defiance s net interest income is determined by its interest rate spread (i.e. the difference between the yields on its interest-earning assets and the rates paid on its interest-bearing liabilities) and the relative amounts of interest-earning assets and interest-bearing liabilities.

As demand for new lending opportunities remains soft in 2010, the Company continues to invest some of its liquidity into investment securities.

Net interest income was $17.8 million for the quarter ended September 30, 2010 compared to $17.6 million for the same period in 2009. The tax-equivalent net interest margin was 3.94% for the quarter ended September 30, 2010 compared to 3.88% for the same period in 2009. The increase in margin between the 2009 and 2010 third quarters is due to a widening of the interest rate spread, which increased to 3.74% for the quarter ended September 30, 2010 compared to 3.64% for the same period in 2009. The increase in spread between the 2009 and 2010 third quarters occurred due to interest-earning asset yields decreasing by 29 basis points (5.31% in the third quarter of 2010 compared to 5.60% in the same period in 2009) which was more than offset by the cost of interest bearing liabilities between the two periods decreasing by 39 basis points (1.57% in the third quarter of 2010 compared to 1.96% in the same period in 2009).

Total interest income decreased by $1.4 million or 5.6% to $24.1 million for the quarter ended September 30, 2010 from $25.5 million for the same period in 2009. The decrease in interest income was due to a decline in asset yields, mainly as a result of a drop in yields on securities which declined 44 basis points to 4.64% at September 30, 2010. Interest income from loans decreased to $22.2 million for the quarter ended September 30, 2010 compared to $23.8 million for the same period in 2009. This decrease is due to the decrease in loan balances coupled with a decline in yield which was 5.72% for the quarter ended September 30, 2010 and 5.85% for the same period in 2009.

Interest expense decreased by $1.6 million in the third quarter of 2010 compared to the same period in 2009, to $6.3 million from $7.9 million. This decrease was due to a 39 basis point decline in the average cost of interest-bearing liabilities in the third quarter of 2010 resulting from a $12.5 million decrease in the average balance of those liabilities in the third quarter of 2010. Interest expense related to interest-bearing deposits was $4.7 million in the third quarter of 2010 compared to $6.2 million for the same period in 2009. Expenses on FHLB advances and notes payable were $1.2 million and $109,000 respectively in the third quarter of 2010 compared to $1.3 million and $140,000 respectively for the same period in 2009. Interest expense recognized by the Company related to subordinated debentures was $332,000 in the third quarter of 2010 compared to $344,000 for the same period in 2009.

Provision for Loan Losses.

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

The provision for loan losses is determined by management as the amount to be added to the allowance for loan losses after net charge-offs have been deducted to bring the allowance to a level which, in management s best estimate, is necessary to absorb probable credit losses within the existing loan portfolio in the normal course of business. The allowance for loan loss is made up of two basic components. The first component is the specific allowance in which the Company sets aside reserves based on the analysis of individual credits. The second component is the general reserve. The general reserve is used to record loan loss reserves for groups of homogenous loans in which the Company estimates the losses incurred in the portfolios based on quantitative and qualitative factors. Due to the uncertainty of risks in the loan portfolio, the Company s judgment on the amount of the allowance necessary to adsorb loans losses is approximate. Table 3 below presents the allocation of the specific and general components of the allowance by signification loan types.

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

For purpose of the general reserve analysis, the loan portfolio is stratified into ten 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 four quarters.

The stratification of the loan portfolio resulted in a quantitative general allowance of $12.7 million at September 30, 2010 compared to $10.5 million at December 31, 2009. The increase in the quantitative allowance was due to the increase in the historical loss factors relating to 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 that have a bearing on its loss content, including but not limited to the following:

- Changes in international, national and local economic and business conditions and developments, including the condition of various market segments;
- Changes in the nature and volume of the loan portfolio;
- Changes in the trends of the volume and severity of past due and classified loans; and changes in trends in the volume of non-accrual loans, troubled debt restructurings and other loan modifications;
- The existence and effect of any concentrations of credit and changes in the level of such concentrations;
- Changes in the value of underlying collateral for collateral dependent loans;
- Changes in the political and regulatory environment;
- Changes in lending policies and procedures, including underwriting standards and collection, charge-off and recovery practices;
- Changes in the experience, ability and depth of lending management and staff; and
- Changes in the quality and breadth of the loan review process.

The qualitative analysis at September 30, 2010 indicated a general reserve of $7.5 million compared with $8.7 million at December 31, 2009. This decrease was mainly driven by improved cash flow and operating results of borrowers in the first nine months of 2010. Management believes that the overall economy and operating environment has stabilized in our markets but still recognizes that high unemployment and declining real estate values in the Midwest remain a concern. While management has seen a reduction in unemployment in its market area, the majority of the counties it serves remain close to double digits. The unemployment rates for August 2010 for the following counties in Ohio were: Allen 10.3%, Defiance 10.9%, Fulton 9.7%, Hancock 8.6%, Henry 10.2%, Lucas 11.1%, Ottawa 9.9%, Paulding 10.5%, Putnam 8.4%, Seneca 10.3%, Williams 11.8% and Wood 9.1%. These rates compare to unemployment rates in December 2009 of the following counties in Ohio were: Allen 11.6%, Defiance 12.8%, Fulton 14.3%, Hancock 9.6%, Henry 13.9%, Lucas 12.3%, Ottawa 17.3%, Paulding 12.7%, Putnam 11.0%, Seneca 13.0%, Williams 14.9% and Wood 11.1%. The Company operates in two counties in Michigan, Hillsdale and Lenawee. The unemployment rate in Hillsdale county was 14.9% in August 2010 compared to 18.2% in December 2009, and the unemployment rate in Lenawee county was 14.7% in August 2010 compared to 16.6% in December 2009. The Company operates in one county in Indiana, Allen, which had an unemployment rate of 12.9% in August 2010 compared to 10.0% in December 2009. August 2010 was the latest available unemployment published information.

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As a result of the quantitative and qualitative analyses, along with the change in specific reserves, the Company s provision for loan losses for the third quarter of 2010 was $5.2 million, compared to $8.1 million for the same period in 2009. The allowance for loan losses was $41.3 million and $36.5 million and represented 2.67% and 2.26% of loans, net of undisbursed loan funds and deferred fees and costs, as of September 30, 2010 and December 31, 2009, respectively. That increase was mainly the result of the decline in real estate values and some collateral dependent loans no longer have enough collateral value to support the outstanding balance. The increase is also attributed to substandard/doubtful loans increasing $13.2 million in the third quarter of 2010 mainly due to four credits which totaled $12.7 million as a result of declining cash flows. Management has expanded its credit monitoring functions even further beyond its traditionally strong focus. Additional asset review functions and more delinquent loan reporting requirements have been added to assist in this monitoring. Management will continually review credit concentrations by the industry and has placed lower limits on lending within certain types of loan categories. Management has also segmented the commercial real estate portfolio to track the general performance of these segments to further refine the predictive process of identifying potential problem loans. The provision was partially offset by charge offs of $2.5 million against specific reserves and $324,000 against general reserves and recoveries of $165,000, resulting in an increase to the overall allowance for loan loss of $2.5 million from June 30, 2010. In management s opinion, the overall allowance for loan losses of $41.3 million as of September 30, 2010 is adequate.

Management also assesses the value of real estate owned as of the end of each accounting period and recognizes write-downs to the value of that real estate in the income statement if conditions dictate. In the third quarter of 2010, First Defiance recorded OREO write-downs that totaled $1.6 million compared to write-downs of $438,000 for the same period in 2009. These write-downs are primarily a result of management s decision to decrease the liquidation values in an effort to spur interest in our market areas to sell these properties and to reflect the impact of writing down to new appraisal amounts received during the quarter. These amounts are included in other non-interest expense. Management believes that the values recorded at September 30, 2010 for real estate owned and repossessed assets represent the realizable value of such assets.

Total classified loans decreased to $127.6 million at September 30, 2010, compared to $128.9 million at December 31, 2009. At September 30, 2010, a total of $50.7 million of loans are classified as substandard for which a specific reserve is required. A total of $74.7 million in additional credits were classified as substandard at September 30, 2010 for which no reserve is required because of factors such as the level of collateral or the strength of guarantors. First Defiance also has classified $2.2 million of loans doubtful at September 30, 2010. By contrast, at December 31, 2009, a total of $46.3 million of loans were classified as substandard for which a specific reserve is required. A total of $78.0 million in additional credits were classified as substandard at December 31, 2009 for which no reserve is required because of factors such as the level of collateral or the strength of guarantors. First Defiance also had classified $4.6 million of loans doubtful at December 31, 2009.

First Defiance s ratio of allowance for loan losses to non-performing loans was 89.56% at September 30, 2010 compared with 76.29% at December 31, 2009. Management monitors collateral values of all loans included on the watch list that are collateral dependent and believes that allowances for those loans at September 30, 2010 are appropriate.

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At September 30, 2010, First Defiance had total non-performing assets of $57.3 million, compared to $61.4 million at December 31, 2009. Non-performing assets include loans that are 90 days past due and on non-accrual, restructured loans and real estate and other assets held for sale. Non-performing assets at September 30, 2010 and December 31, 2009 by category were as follows:

Table 1 Nonperforming Assets

	September 30, 2010	December 31, 2009
	(In thousands)	
Non-performing loans:		
Residential	**$ 6,589**	$ 5,349
Construction	**169**	675
Commercial real estate	**23,421**	24,042
Commercial	**6,955**	10,615
Consumer	**34**	59
Home Equity and improvement	**209**	451
Restructured loans, still accruing	**8,784**	6,715
Total non-performing loans	**46,161**	47,906
Real estate owned and repossessed assets	**11,127**	13,527
Total non-performing assets	**$ 57,288**	$ 61,433

The decrease in non-performing loans between December 31, 2009 and September 30, 2010 is primarily in commercial real estate and commercial loans. The combined balance of these types of non-performing loans was $4.3 million lower at September 30, 2010 compared to December 31, 2009 but was partially offset by a $1.2 million increase in non performing residential loans and a $2.1 million increase in restructured loans.

Non-performing loans in the residential, commercial real estate and commercial loan categories represent 4.92%, 3.59% and 1.96% of the total loans in those categories respectively at September 30, 2010 compared to 3.54%, 3.47% and 2.81% respectively for the same categories at December 31, 2009. With the level of non-performing loans increasing quarter over quarter, management believes that the current allowance for loan losses is appropriate and that the provision for loan losses recorded in the third quarter of 2010 is consistent with both charge-off experience and the risk inherent in the overall credits in the portfolio.

Asset quality ratios for First Defiance were as follows at September 30, 2010 and December 31, 2009:

Table 2 Nonperforming Asset Ratios

	September 30, 2010	December 31, 2009
Allowance for loan losses as a percentage of total loans*	**2.67%**	2.26%
Allowance for loan losses as a percentage of non- performing assets	**72.17%**	59.49%
Allowance for loan losses as a percentage of non- performing loans	**89.56%**	76.29%
Total non-performing assets as a percentage of total assets	**2.81%**	2.99%
Total non-performing loans as a percentage of total loans*	**2.98%**	2.96%

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

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

The following table discloses charge-offs, recoveries and provision expense for the quarter ended September 30, 2010 by loan category ($ in thousands). The decline in the commercial real estate general provision in the third quarter of 2010 was mainly due to a reduction in the related principal balances of $13.5 million from June 30, 2010.

Table 3 Charge-offs, Recoveries and Provision by Category

Quarter Ended September 30, 2010	Commercial Real Estate	Commercial	Consumer	Residential	Construction	Home Equity and improvement	Total
Allowance for loans individually evaluated							
Beginning Specific Allocations	$ 10,208	$ 4,275	$ 49	$ 3,892	$ 160	$ 327	$ 18,911
Charge-Offs	(647)	(840)	(12)	(978)		(69)	(2,546)
Recoveries							
Provisions	3,553	562	46	258	(11)	377	4,785
Ending Specific Allocations	$ 13,114	$ 3,997	$ 83	$ 3,172	$ 149	$ 635	$ 21,150
Allowance for loans collectively evaluated							
Beginning General Allocations	$ 9,729	$ 6,106	$ 446	$ 2,693	$ 54	$ 913	$ 19,941
Charge-Offs	(41)	(2)	(16)	(186)		(79)	(324)
Recoveries	8	83	32	36		6	165
Provisions	(516)	495	(18)	446	(14)	18	411
Ending General Allocations	$ 9,180	$ 6,682	$ 444	$ 2,989	$ 40	$ 858	$ 20,193

The following table details net charge-offs and nonaccrual loans by loan type. For the three months ended and as of September 30, 2010, commercial real estate, which represented 49.8% of total loans, accounted for 25.1% of net charge-offs and 62.7% of nonaccrual loans, and commercial loans, which represented 23.9% of total loans, accounted for 28.1% of net charge-offs and 18.6% of nonaccrual loans. For the three months ended and as of September 30, 2009, commercial real estate, which represented 48.7% of total loans, accounted for 42.5% of net charge-offs and 65.6% of nonaccrual loans, and commercial loans, which represented 22.6% of total loans, accounted for 23.1% of net charge-offs and 15.7% of nonaccrual loans.

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Table 4 Net Charge-offs and Non-accruals by Loan Type

	For the Three Months Ended September 30, 2010		As of September 30, 2010	
	Net Charge-offs	% of Total Net Charge-offs	Nonaccrual Loans	% of Total Non-Accrual Loans
	(in thousands)		*(in thousands)*	
Residential	$ 1,128	41.70%	$ 6,589	17.63%
Construction		0.0%	169	0.45%
Commercial real estate	680	25.14%	23,421	62.66%
Commercial	759	28.06%	6,955	18.61%
Consumer	(4)	(0.15%)	34	0.09%
Home equity and improvement	142	5.25%	209	0.56%
Total	$ 2,705	100.0%	$ 37,377	100.0%

	For the Three Months Ended September 30, 2009		As of September 30, 2009	
	Net Charge-offs	% of Total Net Charge-offs	Nonaccrual Loans	% of Total Non-Accrual Loans
	(in thousands)		*(in thousands)*	
Residential	$ 720	27.24%	$ 5,839	16.45%
Construction		0.0%	194	0.55%
Commercial real estate	1,123	42.49%	23,278	65.59%
Commercial	610	23.08%	5,569	15.68%
Consumer	(6)	(0.23)%	45	0.14%
Home equity and improvement	196	7.42%	565	1.59%
Total	$ 2,643	100.0%	$ 35,490	100.0%

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Credit Quality Profile

The following table discloses the period end balances for the loan portfolio by payment status as of September 30, 2010 and December 31, 2009.

Table 5 Credit Quality Profile

	Total Balance	Current and Performing	30 to 89 days past due*	Non Accrual Loans	Troubled Debt Restructuring	Non Accrual %	> 30 Days Past Due and Non Accrual %
	(dollars in thousands)						
September 30, 2010							
Residential	$ 213,574	$ 200,573	$ 2,483	$ 6,589	$ 3,929	3.09%	4.25%
Construction	31,722	31,553		169		0.53%	0.53%
Commercial real estate	776,972	745,663	3,420	23,421	4,468	3.01%	3.45%
Commercial	372,583	364,958	318	6,955	352	1.87%	1.95%
Consumer finance	27,060	26,842	184	34		0.13%	0.81%
Home equity and improvement	137,747	135,825	1,678	209	35	0.15%	1.37%
Total loans	$ 1,559,658	$ 1,505,414	$ 8,083	$ 37,377	$ 8,784	2.40%	2.91%
Total Number of Loans	20,406	19,977	187	202	40		
December 31, 2009							
Residential	$ 227,592	$ 215,209	$ 4,333	$ 5,349	$ 2,701	2.35%	4.25%
Construction	48,625	47,950		675		1.39%	1.39%
Commercial real estate	806,890	775,604	3,280	24,042	3,964	2.98%	3.39%
Commercial	379,408	367,592	1,151	10,615	50	2.80%	3.10%
Consumer finance	34,105	33,669	377	59		0.17%	1.28%
Home equity and improvement	147,977	145,481	2,045	451		0.30%	1.69%
Total loans	$ 1,644,597	$ 1,585,505	$ 11,186	$ 41,191	$ 6,715	2.51%	3.18%
Total Number of Loans	22,109	21,504	281	283	41		

* There are 5 residential loans totaling $650,000 and 5 commercial real estate loans totaling $1,258,000 that are not included in the 30 to 89 days past due column as they are classified as troubled debt and are included in that category at September 30, 2010. At December 31, 2009, there was 1 such residential loan with a balance of $385,000.

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The table below is the credit risk profile trend for the last five quarters using the Company s internally assigned loan grades. This table was created using data required to be compliant with the Company s reporting on the thrift financial report.

Table 6 Credit Risk Profile Trend

Commercial Real Estate	3rd Qtr 2010	2nd Qtr 2010	1st Qtr 2010	4th Qtr 2009	3rd Qtr 2009
Grade					
Pass	$ 677,645	$ 686,323	$ 690,172	$ 698,903	$ 695,848
Special Mention	29,398	46,272	41,401	35,780	30,672
Substandard/Doubtful	69,929	57,926	65,876	72,207	75,914
Total by Exposure	$ 776,972	$ 790,521	$ 797,449	$ 806,890	$ 802,434

Commercial	3rd Qtr 2010	2nd Qtr 2010	1st Qtr 2010	4th Qtr 2009	3rd Qtr 2009
Grade					
Pass	$ 303,479	$ 307,791	$ 294,765	$ 322,152	$ 333,797
Special Mention	34,764	24,172	23,029	22,441	12,479
Substandard/Doubtful	34,340	32,318	35,129	34,815	25,605
Total by Exposure	$ 372,583	$ 364,281	$ 352,923	$ 379,408	$ 371,881

Residential	3rd Qtr 2010	2nd Qtr 2010	1st Qtr 2010	4th Qtr 2009	3rd Qtr 2009
Grade					
Pass	$ 184,247	$ 191,796	$ 196,452	$ 203,649	$ 212,140
Special Mention	9,455	4,778	5,372	3,897	3,769
Substandard/Doubtful	19,872	21,029	20,275	20,046	18,049
Total by Exposure	$ 213,574	$ 217,603	$ 222,099	$ 227,592	$ 233,958

Construction	3rd Qtr 2010	2nd Qtr 2010	1st Qtr 2010	4th Qtr 2009	3rd Qtr 2009
Grade					
Pass	$ 29,243	$ 40,652	$ 42,129	$ 45,091	$ 50,655
Special Mention	403	403	403	2,768	2,850
Substandard/Doubtful	2,076	2,278	3,837	766	100

Total by Exposure	$ 31,722	$ 43,333	$ 46,369	$ 48,625	$ 53,605

Consumer	3rd Qtr 2010	2nd Qtr 2010	1st Qtr 2010	4th Qtr 2009	3rd Qtr 2009
Grade					
Pass	$ 26,882	$ 28,832	$ 31,600	$ 33,935	$ 36,132
Special Mention					
Substandard/Doubtful	178	129	118	170	284
Total by Exposure	$ 27,060	$ 28,961	$ 31,718	$ 34,105	$ 36,416

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Home Equity and Improvement	3rd Qtr 2010	2nd Qtr 2010	1st Qtr 2010	4th Qtr 2009	3rd Qtr 2009
Grade					
Pass	$ 136,499	$ 140,223	$ 143,371	$ 147,076	$ 148,805
Special Mention					
Substandard/Doubtful	1,248	746	1,455	901	1,574
Total by Exposure	$ 137,747	$ 140,969	$ 144,826	$ 147,977	$ 150,379

Total	3rd Qtr 2010	2nd Qtr 2010	1st Qtr 2010	4th Qtr 2009	3rd Qtr 2009
Grade					
Pass	$ 1,357,995	$ 1,395,617	$ 1,398,489	$ 1,450,806	$ 1,477,377
Special Mention	74,020	75,625	70,205	64,886	49,770
Substandard/Doubtful	127,643	114,426	126,690	128,905	121,526
Total by Exposure	$ 1,559,658	$ 1,585,668	$ 1,595,384	$ 1,644,597	$ 1,648,673

The following table sets forth the activity in First Defiance s allowance for loan losses during the periods indicated.

Table 7 Allowance for Loan Loss Activity

	For the Quarter Ended				
	3rd 2010	2nd 2010	1st 2010	4th 2009	3rd 2009
	(Dollars in Thousands)				
Allowance at beginning of period	$ 38,852	$ 38,980	$ 36,547	$ 31,248	$ 25,840
Provision for credit losses	5,196	5,440	6,889	8,470	8,051
Charge-offs:					
Residential	1,164	1,135	326	884	744
Commercial real estate	688	1,243	3,191	1,912	1,152
Commercial	842	3,153	735	354	658
Consumer finance	28	16	25	75	39
Home equity and improvement	148	156	399	135	196
Total charge-offs	2,870	5,703	4,676	3,360	2,789
Recoveries	165	135	220	189	146
Net charge-offs	2,705	5,568	4,456	3,171	2,643
Ending allowance	$ 41,343	$ 38,852	$ 38,980	$ 36,547	$ 31,248

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

Table 8 Allowance for Loan Loss Allocation by Loan Category

	September 30, 2010		June 30, 2010		March 31, 2010		December 31, 2009		September 30, 2009	
	Amount	Percent of total loans by category	Amount	Percent of total loans by category	Amount	Percent of total loans by category	Amount	Percent of total loans by category	Amount	Percent of total loans by category
Residential	$ 6,161	13.69%	$ 6,585	13.72%	$ 6,093	13.92%	$ 5,827	13.84%	$ 5,395	14.19%
Construction	189	2.03%	214	2.73%	717	2.91%	221	2.96%	113	3.25%
Commercial real estate	22,294	49.82%	19,939	49.85%	19,354	49.98%	18,876	49.06%	16,107	48.67%
Commercial	10,679	23.89%	10,381	22.97%	10,672	22.12%	9,444	23.07%	7,183	22.56%
Consumer	527	1.74%	494	1.83%	402	1.99%	515	2.07%	618	2.21%
Home equity and improvement	1,493	8.83%	1,239	8.89%	1,742	9.08%	1,664	9.00%	1,832	9.12%
	$ 41,343	100.00%	$ 38,852	100.00%	$ 38,980	100.00%	$ 36,547	100.00%	$ 31,248	100.00%

Key Asset Quality Ratio Trends

Table 9 Key Asset Quality Ratio Trends

	3rd Qtr 2010	2nd Qtr 2010	1st Qtr 2010	4th Qtr 2009	3rd Qtr 2009
Allowance for loan losses / loans*	2.67%	2.47%	2.47%	2.26%	1.92%
Allowance for loan losses to net charge-offs	1,528.39%	697.77%	874.78%	1,152.54%	1,182.29%
Allowance for loan losses / non-performing assets	72.17%	72.68%	73.05%	59.49%	63.23%
Allowance for loan losses / non-performing loans	89.56%	95.41%	96.03%	76.29%	78.00%
Non-performing assets / loans plus REO*	3.67%	3.37%	3.36%	3.77%	3.03%
Non-performing assets / total assets	2.81%	2.62%	2.59%	2.99%	2.45%
Net charge-offs / average loans (annualized)	0.70%	1.44%	1.14%	0.79%	0.66%

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

Non-Interest Income.

Total non-interest income increased $1.9 million to $7.5 million in the third quarter of 2010 compared to the same period in 2009 due primarily to an increase in mortgage banking income.

Service Fees. Service fees and other charges decreased by $276,000 or 7.7% in the 2010 third quarter compared to the same period in 2009. The decrease is a result of lower NSF fee income in the third quarter of 2010 of $368,000 compared to the same period in 2009 mainly due to the effect of Reg-E which took effect July 1, 2010 for new customers and August 15, 2010 for existing customers.

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, or an ATM. To be in good standing, an account must be brought to a positive balance within a 30-day period. 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. Accounts overdrawn for more than 60 days are automatically charged off. Fees are charged as a one-time fee per occurrence 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. Beginning on July 1, 2010 for new customers and August 15, 2010 for existing customers, federal rules will prohibit a financial institution from assessing a fee to complete an ATM withdrawal or one-time debit card transaction which will cause an overdraft unless the customer consents in advance (opts-in). Fee income recorded for the quarters ending September 30, 2010 and 2009 related to the overdraft privilege product, net of adjustments to the allowance for uncollectible overdrafts, were $1.9 million and $2.3 million, respectively. Accounts charged off are included in noninterest expense. The allowance for uncollectible overdrafts was $77,000 at September 30, 2010, $114,000 at December 31, 2009 and $104,000 at September 30, 2009.

Mortgage Banking Activity. Total revenue from the sale and servicing of mortgage loans increased $1.3 million to $2.3 million for the third quarter of 2010 compared to $1.0 million for the same period of 2009. This increase was primarily due to higher loan origination volume for the quarter, the result of higher refinancing activity due to lower interest rates on conforming saleable mortgage-based products in the third quarter of 2010 compared to the same period in 2009. Gains realized from the sale of mortgage loans increased in the third quarter of 2010 to $2.9 million from $1.5 million in the third quarter of 2009. Mortgage loan servicing revenue increased $36,000 in the third quarter of 2010 compared to the third quarter of 2009. The increase in gains were partially offset by expense increases of $284,000 for the amortization of mortgage servicing rights due to the higher refinance activity during the third quarter of 2010. The Company recorded a negative valuation adjustment of $527,000 on mortgage servicing rights in the third quarter of 2010 compared to a negative valuation adjustment of $772,000 in the third quarter of 2009. This was driven by a steady decrease in market mortgage rates late in the second quarter of 2010 and into the third quarter of 2010. This decrease in rates increased the assumed prepayment speed of the mortgage servicing rights.

Loss on Sale or Write-Down of Securities. Non-interest income also includes investment securities gains or losses. In the third quarter of 2010, First Defiance recognized other-than-temporary impairment (OTTI) charges of $190,000 for certain impaired investment securities, where in management s opinion, the value of the investment will not be fully recovered. The OTTI charge related to two Trust Preferred Collateralized Debt Obligation (CDO) investments with a remaining book value of $860,000 and preferred stock in Fannie Mae and Freddie Mac with a remaining combined book value of $35,000. In the third quarter of 2009, First Defiance recognized OTTI charges of $994,000 for certain impaired investment securities, where in management s opinion, the value of the investment will not be recovered. The OTTI charge related to five CDOs with a remaining book value of $2.2 million. In the third quarter of 2009, nine available for sale securities were sold for a gain of $154,000.

Non-Interest Expense.

Non-interest expense increased to $17.1 million for the third quarter of 2010 compared to $14.8 million for the same period in 2009.

Compensation and Benefits. Compensation and benefits increased to $7.1 million for the quarter ended September 30, 2010 from $6.6 million for the same period in 2009. The increase is mainly attributable to a reduction in variable compensation in the third quarter of 2009 due to the performance of the Company not meeting its target as well as a reduction in employees.

FDIC insurance premium. FDIC insurance expense increased to $907,000 in the third quarter of 2010 from $649,000 in the same period of 2009. This was the result of the FDIC rate increases and higher insured deposits.

Other Non-Interest Expenses. Other non-interest expenses (including state franchise tax, data processing, amortization of intangibles and other) increased by $1.6 million to $7.3 million for the quarter ended September 30, 2010 from $5.7 million for the same period in 2009. Increases between the 2010 and 2009 third quarters include an increase in credit, collection and OREO expenses of $1.1 million for other real estate owned and repossessed assets, $410,000 of losses related to the buy-back of secondary market sold loans and $40,000 of expenses incurred related to the core system conversion scheduled for the fourth quarter of 2010. The following table below shows the quarterly ending balances of these major expense categories.

Table 10 Key Quarterly Non-Interest Expense Variances

3 Months Ended	9-30-10	6-30-10	3-31-10	12-31-09	9-30-09
Credit and Collection Expense	$ 282,278	$ 355,559	$ 349,435	$ 300,065	$ 344,255
REO Expenses	2,054,818	698,710	798,394	351,436	863,245
Loss on Secondary Market Buy-Backs	409,848	90,704		280,955	
Core Conversion Costs	39,584	346,189	71,106		

Credit and collection expenses are mainly legal costs incurred in the normal course of collecting a debt. REO expenses are mainly the write-downs taken primarily due to a change in the value of the foreclosed asset as well as costs to maintain the property such as real estate taxes and repairs. Loss on secondary market buy-backs are those losses or expenses the Company is required to reimburse Fannie Mae or Freddie Mac for sold loans not meeting certain underwriting criteria. Core conversion expenses are mainly consulting expenses, deconversion fees and training costs.

The efficiency ratio, considering tax equivalent interest income and excluding securities gains and losses, for the third quarter of 2010 was 66.42% compared to 60.90% for the third quarter of 2009.

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 22.70% for the quarter ended September 30, 2010 compared to (12.67)% for the same period in 2009. The increase in the effective tax rate for the quarter ended September 30, 2010 is mainly due to the increase in net income as a result of a lower provision expense in the third quarter of 2010 compared to the same period in 2009.

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Nine Months Ended September 30, 2010 and 2009

On a consolidated basis, First Defiance s net income for the nine months ended September 30, 2010 was $5.8 million compared to income of $6.6 million for the comparable period in 2009. Net income applicable to common shares was $4.3 million for the nine months ended September 30, 2010 compared to $5.1 million for the comparable period in 2009. On a per share basis, basic and diluted earnings per common share for the nine months ended September 30, 2010 were both $0.53 compared to basic and diluted earnings per common share of $0.63 for the nine months ended September 30, 2009.

Net Interest Income.

Net interest income was $52.4 million for the nine months ended September 30, 2010 compared to $49.8 million for the same period in 2009. For the nine month period ended September 30, 2010, total interest income was $72.5 million, a $2.9 million decrease from the same period in 2009. Despite average earning assets increasing $21.5 million in the first nine months of 2010, the average yield declined 25 basis points as a result of a lower rate environment.

Interest expense decreased by $5.5 million to $20.1 million for the nine months ended September 30, 2010 compared to $25.6 million in the first nine months of 2009. While the average balance of interest-bearing liabilities increased by $14.1 million between the first nine months of 2009 and 2010, the expense associated with the higher balance was more than offset by a decline in the average cost of interest-bearing deposits for the nine months ending September 30, 2010, to 1.50%, a 44 basis point decrease from the 1.94% average cost in the first nine months of 2009. This decline is the result of the continued low rate environment which has given management opportunities to re-price on the liability side.

Provision for Loan Losses.

The provision for loan losses was $17.5 million for the nine months ended September 30, 2010, compared to $14.8 million during the nine months ended September 30, 2009. The year over year increase was primarily the result of the deterioration of a number of large credits in the commercial loan portfolio along with a decline in the overall economy in the Company s primary market area. Charge-offs for the first nine months of 2010 were $13.2 million and recoveries of previously charged off loans totaled $520,000 for net charge-offs of $12.7 million. By comparison, $8.5 million of charge-offs were recorded in the same period of 2009 and $360,000 of recoveries were realized for net charge-offs of $8.1 million.

Non-Interest Income.

Total non-interest income decreased to $20.0 million for the nine months ended September 30, 2010 from $20.7 million recognized in the same period of 2009.

Service Fees. Service fees and other charges decreased by $133,000 or 1.3% in the nine months ended September 30, 2010 compared to the same period in 2009. The decrease is the result of Reg-E as described above.

Mortgage Banking Activity. Total revenue from the sale and servicing of mortgage loans decreased 33.4% to $5.1 million for the nine months ended September 30, 2010 from $7.7 million for the same period of 2009. Gains realized from the sale of mortgage loans decreased $2.0 million to $5.3 million for the first nine months of 2010 from $7.3 million during the same period of 2009. Mortgage loan servicing revenue increased $154,000 in the first nine months of 2010 compared to the same period of 2009. The decrease in gains were partially offset by expense decreases of $991,000 for the amortization of mortgage servicing rights in the first nine months of 2010 when compared to the same period of 2009. The Company recorded a negative valuation adjustment of $777,000 in the first nine months of 2010 compared to a positive adjustment of $917,000 in the same period of 2009. The mortgage servicing rights valuation was driven by a steady decline in market mortgage rates late in the second quarter of 2010 and into the third quarter of 2010.

Insurance and Investment Sales Commission. Insurance and investment sales commission income decreased $107,000, to $3.8 million for the nine months ended September 30, 2010, from $3.9 million during the same period of 2009. This is the result of receiving less contingent commission income in the first nine months of 2010 compared to the same period of 2009. In 2010, $104,000 was received compared to $432,000 in 2009.

Loss on Securities. Non-interest income was reduced in the first nine months of 2010 by $325,000 as First Defiance recognized $331,000 of other-than-temporary impairment charges for certain impaired investment securities partially offset by the gain on sale of $6,000 from available for sale securities. In the first nine months of 2009, $2.5 million of OTTI charges were recorded on impaired investments, partially offset by the $279,000 gain recorded from the sale of available for sale securities.

Non-Interest Expense.

Non-interest expense increased to $47.0 million for the first nine months of 2010 compared to $45.9 million for the same period in 2009. The year-to-date 2010 amount includes $53,000 of non-recurring costs associated with the acquisition of a group medical benefits line of business in May 2010.

Compensation and Benefits. Compensation and benefits decreased to $20.2 million for the first nine months ended September 30, 2010 from $21.5 million for the same period in 2009. A significant part of this decrease relates to management s decision to preemptively reduce staff levels as well as to allow attrition to reduce staffing levels. The Company had 502 full-time equivalent employees as of September 30, 2010 compared to 520 as of September 30, 2009.

Occupancy. Occupancy costs decreased $637,000 in the first nine months of 2010. This decrease can be attributed to the cost savings from closing several branches in January 2010 as previously announced in the Company s 2009 10-K.

Other Non-Interest Expenses. Other non-interest expenses (including state franchise tax, data processing, amortization of intangibles and other) increased by $2.8 million to $18.6 million for the first nine months of 2010 from $15.8 million for the same period in 2009. Significant increases between the first nine months of 2010 and 2009 include an increase in credit, collection and OREO expenses of $1.8 million for other real estate owned and repossessed assets and $457,000 of expenses related to the core system conversion that will take place later in 2010. These costs were partially offset by a decrease in office supply expense (down $53,000) and country club memberships (down $32,000) as a direct result of management s cost control initiative.

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Table 11 Key Year-To-Date Non-Interest Expense Variances

9 Months Ended	9-30-10	9-30-09
Credit and Collection Expense	$ 987,272	$ 816,781
REO Expenses	3,551,922	1,893,393
Core Conversion Costs	456,879	

Credit and collection expenses are mainly legal costs incurred in the normal course of collecting a debt. REO expenses are mainly the write-downs taken primarily due to a change in the value of the foreclosed asset as well as costs to maintain the property such as real estate taxes and repairs. Core conversion expenses are mainly consulting expenses, deconversion fees and training costs.

The efficiency ratio for the first nine months of 2010 was 63.75% compared to 62.36% for the same period of 2009.

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 $17.2 million of cash provided by operating activities during the first nine months of 2010. The Company s cash used in operating activities resulted from the origination of loans held for sale mostly offset by the proceeds on the sale of loans.

At September 30, 2010, First Defiance had $95.3 million in outstanding loan commitments and loans in process to be funded generally within the next nine months and an additional $256.2 million committed under existing consumer and commercial lines of credit and standby letters of credit. Also at that date, First Defiance had commitments to sell $92.3 million of loans held-for-sale. Also, the total amount of certificates of deposit that are scheduled to mature by September 30, 2011 is $404.8 million. 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 we may not be able to meet our financial obligations and operating cash needs or may become overly reliant upon external funding sources. In order to manage this risk, our Board of Directors has established an Liquidity Policy that identifies primary sources of liquidity, establishes procedures for monitoring and measuring liquidity and quantifies minimum liquidity requirements. This policy designates our 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.

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ALCO uses an economic value of equity (EVE) analysis to measure risk in the balance sheet incorporating all cash flows over the estimated remaining life of all balance sheet positions. The EVE analysis calculates the net present value of First Federal s assets and liabilities in rate shock environments that range from -400 basis points to +400 basis points. The likelihood of a decrease in rates as of September 30, 2010 was considered to be remote given the current interest rate environment and therefore, was not included in this analysis. The results of this analysis are reflected in the following tables for the nine months ended September 30, 2010 and the year-ended December 31, 2009.

	September 30, 2010 Economic Value of Equity		
Change in Rates	**$ Amount**	**$ Change**	**% Change**
	(Dollars in Thousands)		
+ 400 bp	285,204	(12,744)	(4.28%)
+ 300 bp	289,973	(7,974)	(2.68%)
+ 200 bp	294,296	(3,652)	(1.23%)
+ 100 bp	297,269	(679)	(0.23%)
0 bp	297,948		

	December 31, 2009 Economic Value of Equity		
Change in Rates	**$ Amount**	**$ Change**	**% Change**
	(Dollars in Thousands)		
+ 300 bp	263,012	(9,820)	(3.60%)
+ 200 bp	267,908	(4,924)	(1.80%)
+ 100 bp	270,927	(1,905)	(0.70%)
0 bp	272,932		

Capital Resources

First Federal is required to maintain specified amounts of capital pursuant to regulations promulgated by the OTS. The capital standards generally require the maintenance of regulatory capital sufficient to meet a tangible capital requirement, a core capital requirement, and a risk-based capital requirement. The following table sets forth First Federal s compliance with each of the capital requirements at September 30, 2010 (in thousands).

	Core Capital		Risk-Based Capital	
	Adequately Capitalized	**Well Capitalized**	**Adequately Capitalized**	**Well Capitalized**
Regulatory capital	$ 211,594	$ 211,594	$ 233,072	$ 233,072
Minimum required regulatory capital	79,036	98,794	136,397	170,496
Excess regulatory capital	$ 132,558	$ 112,800	$ 96,675	$ 62,576
Regulatory capital as a percentage of assets (1)	10.71%	10.71%	13.67%	13.67%
Minimum capital required as a percentage of assets	4.00%	5.00%	8.00%	10.00%
Excess regulatory capital as a percentage of assets	6.71%	5.71%	5.67%	3.67%

(1) Core capital is computed as a percentage of adjusted total assets of $2.0 billion. Risk-based capital is computed as a percentage of total risk-weighted assets of $1.7 billion.

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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, Valuation of 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 nine months of 2010.

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Item 3. Quantitative and Qualitative Disclosures About Market Risk

As discussed in detail in the 2009 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 which measures the impact changes in interest rates can have on net income. The simulation technique analyzes the effect of a presumed 100 and 200 basis point shift in interest rates 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 or fall 100 basis points (which is consistent with management s estimate of the range of potential interest rate fluctuations) over a 12 month period, using September 30, 2010 amounts as a base case, First Defiance s net interest income would be impacted by less than the board mandated guidelines of 10%.

First Defiance will be monitoring its exposure to interest rate risk on a more robust basis on a quarterly basis going forward. By using multiple simulation techniques to analyze the effect of a presumed 100, 200, 300 and 400 basis point shift in interest rates taking into consideration account level prepayment speeds on amortizing financial instruments, loan and deposit volumes and rates, non-maturity deposit assumptions and capital requirements.

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

An evaluation was carried out under the supervision and with the participation of the Company s management, including the Chief Executive Officer and the Chief Financial Officer, of the effectiveness of the Company s disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934) as of September 30, 2010. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company s disclosure controls and procedures were effective. No changes occurred in the Company s internal controls over financial reporting during the quarter ended September 30, 2010 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

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

Item 1A. Risk Factors

There are no material changes from the risk factors set forth under Part I, Item 1A. Risk Factors in the Company s Annual Report on Form 10-K for the year ended December 31, 2009. The risk factors described in the Annual Report on Form 10-K are not the only risks facing the Company. Additional risks and uncertainties not currently known to the Company or that management currently deems to be immaterial also may materially adversely affect the Company s business, financial condition and/or operating results. Moreover, the Company undertakes no obligation and disclaims any intention to publish revised information or updates to forward looking statements contained in such risk factors or in any other statement made at any time by the Company or any of its directors, officers, employees or other representatives, unless and until any such revisions or updates are expressly required to be disclosed by securities laws or regulations.

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

First Defiance did not have any common stock repurchases during the first nine months of 2010, but has 93,124 shares that may be purchased under a plan announced by the Board of Directors on July 18, 2003. Participation in the CPP prohibits the Company from repurchasing any of its common shares without the prior approval of the U.S. Treasury until the earlier of December 5, 2011 or the date the U.S. Treasury s preferred stock is redeemed or transferred to an unaffiliated third party.

Item 3. Defaults upon Senior Securities

Not applicable.

Item 4. Removed and Reserved

Item 5. Other Information

Not applicable.

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Item 6. Exhibits

Exhibit 10.1 First Federal Bank of the Midwest Executive Group Life Plan Post Separation, as amended

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

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

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

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

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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 by the undersigned thereunto duly authorized.

	First Defiance Financial Corp. (Registrant)
Date: November 2, 2010	By: /s/ William J. Small William J. Small Chairman, President and Chief Executive Officer
Date: November 2, 2010	By: /s/ Donald P. Hileman Donald P. Hileman Executive Vice President and Chief Financial Officer

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