

RURBAN FINANCIAL CORP
Form 10-K
March 30, 2012

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(Mark One)

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2011

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____

Commission File Number 0-13507

RURBAN FINANCIAL CORP.

(Exact name of Registrant as specified in its charter)

Ohio 34-1395608
(State or other jurisdiction of (I.R.S. Employer
incorporation or organization) Identification No.)

401 Clinton Street, Defiance, Ohio 43512
(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code: (419)
783-8950

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

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<u>Title of each class</u>	Name of each exchange on which registered
Common Shares, Without Par Value	The NASDAQ Stock Market, LLC

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

Not Applicable

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes ☐ No ☒

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.

Yes ☐ No ☒

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer", "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. Large Accelerate Filer ☐ Accelerated Filer ☐ Non-Accelerated Filer ☐ Smaller Reporting Company ☒

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

The aggregate market value of the common shares of the registrant held by non-affiliates computed by reference to the price at which the common shares were last sold as of the last business day of the registrant's most recently completed second fiscal quarter was \$14,828,426.

The number of common shares of the registrant outstanding at March 30, 2012 was 4,861,779.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant's 2011 Annual Report are incorporated by reference in Part II of this Annual Report on Form 10-K.

Portions of the Registrant's definitive Proxy Statement for its Annual Meeting of Shareholders to be held on April 26, 2012 are incorporated by reference into Part III of this Annual Report on Form 10-K.

RURBAN FINANCIAL CORP.

2011 ANNUAL REPORT ON FORM 10-K

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PART I

Item 1. Business.

Certain statements contained in this Annual Report on Form 10-K which are not statements of historical fact constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. See “Cautionary Statement Regarding Forward-Looking Information” under *Item 1A. Risk Factors* on page 11 of this Annual Report on Form 10-K.

General

Rurban Financial Corp., an Ohio corporation (the “Company”), is a bank holding company registered under the Bank Holding Company Act of 1956, as amended, and is subject to regulation by the Board of Governors of the Federal Reserve System (the “Federal Reserve Board”). The Company was organized in 1983. The executive offices of the Company are located at 401 Clinton Street, Defiance, Ohio 43512.

Through its direct and indirect subsidiaries, The State Bank and Trust Company (“State Bank”), RFCBC, Inc. (“RFCBC”), Rurbanc Data Services, Inc. dba RDSI Banking Systems (“RDSI”), Rurban Mortgage Company (“RMC”), Rurban Investments, Inc. (“RII”), SBT Insurance, LLC (“SBI”), Rurban Statutory Trust I (“RST I”), and Rurban Statutory Trust II (“RST II”), the Company is engaged in a variety of activities, including commercial banking, data and item processing, and trust and financial services, as explained in more detail below. State Bank owns all of the outstanding stock of Rurban Mortgage Company (“RMC”), Rurban Investments Inc. (“RII”) and SBT Insurance, LLC (“SBI”).

General Description of Holding Company Group

State Bank

State Bank is an Ohio state-chartered bank, which offers a full range of commercial banking services, including checking accounts, passbook savings, money market accounts and time certificates of deposit; automatic teller machines; commercial, consumer, agricultural and residential mortgage loans (including “Home Value Equity” line of credit loans); personal and corporate trust services; commercial leasing; bank credit card services; safe deposit box rentals; Internet and telephone banking; and other personalized banking services. The trust and financial services division of State Bank, Reliance Financial Services (“RFS”), offers various trust and financial services, including asset management services for individuals and corporate employee benefit plans, as well as brokerage services through PrimeVest Financial Services. State Bank presently operates nineteen banking centers located within the Ohio counties of Allen, Defiance, Fulton, Lucas, Paulding, Wood and Williams, and one located in Allen County, Indiana. State Bank also presently operates two Loan Production Offices, one in Franklin County, Ohio and one in Steuben County, Indiana. At December 31, 2011, State Bank had 182 full-time equivalent employees.

RFCBC

RFCBC is an Ohio corporation and wholly-owned subsidiary of the Company that was incorporated in August 2004. RFCBC operates as a loan subsidiary in servicing and working out problem loans. At December 31, 2011, RFCBC had no employees.

RDSI

RDSI has been in operation since 1964 and became an Ohio corporation in June 1976. RDSI has one operating location in Defiance, Ohio. In September 2006, RDSI acquired Diverse Computer Marketers, Inc. ("DCM") which was merged into RDSI effective December 31, 2007, and now operates as a division of RDSI doing business as "DCM". DCM has one operating location in Lansing, Michigan.

RDSI provides item processing and related services to community banks located in Illinois, Indiana, Kentucky, Michigan, Ohio and Wisconsin. At December 31, 2011, RDSI had 26 full-time equivalent employees.

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RMC

RMC is an Ohio corporation and wholly-owned subsidiary of State Bank. RMC is a mortgage company; however, it ceased originating mortgage loans in the second quarter of 2000 and is presently inactive. At December 31, 2011, RMC had no employees.

RII

RII is a Delaware corporation and wholly-owned subsidiary of State Bank. RII is an investment company that engages in the purchase and sale of investments. At December 31, 2011, RII had no employees.

SBI

SBI is an Ohio corporation and wholly-owned subsidiary of State Bank. SBI is an insurance company that engages in the sale of insurance products to retail and commercial customers of State Bank. At December 31, 2011, SBI had no employees.

RST I

RST I is a trust that was organized in August 2000. In September 2000, RST I closed a pooled private offering of 10,000 Capital Securities with a liquidation amount of \$1,000 per security. The proceeds of the offering were loaned to the Company in exchange for junior subordinated debentures with terms similar to the Capital Securities. The sole assets of RST I are the junior subordinated debentures and the back-up obligations, which in the aggregate, constitute a full and unconditional guarantee by the Company of the obligations of RST I under the Capital Securities.

RST II

RST II is a trust that was organized in August 2005. In September 2005, RST II closed a pooled private offering of 10,000 Capital Securities with a liquidation amount of \$1,000 per security. The proceeds of the offering were loaned to the Company in exchange for junior subordinated debentures with terms similar to the Capital Securities. The sole assets of RST II are the junior subordinated debentures and the back-up obligations, which in the aggregate, constitute a full and unconditional guarantee by the Company of the obligations of RST II under the Capital Securities.

Recent Developments

The Company returned to profitability during 2011 with net income of \$1.7 million. This was a dramatic improvement from the loss of \$15.6 million incurred for 2010. Our Banking subsidiary, State Bank, had net income of \$4.8 million, while our technology subsidiary, RDSI, lost \$1.4 million during 2011.

Improvements in problem assets continued to be a strong part of the Company's increase in profitability during 2011. At December 31, 2011, non-performing assets had declined \$3.8 million from the prior year. The level of non-performing assets to total assets fell to 1.77 percent from 2.26 percent for the prior year. (The Company began to include accruing restructured loans in non-performing assets during 2011). Loan delinquency ended the year at 1.54 percent of total loans at December 31, 2011, versus 2.77 percent at December 31, 2010.

Mortgage loan production continued to be a significant part of our business model during 2011. For the year, the Company originated \$220 million in residential loans. During the year, the Company sold \$199 million of originated balances and had net mortgage banking revenue of \$2.7 million.

Operating expense was reduced dramatically during 2011 as expenses at RDSI declined due to customer losses and goodwill impairment. State Bank made efforts to become more efficient with the reduction of 14 FTE.

4.

State Bank's loan loss provision totaled \$2.0 million for 2011, which was down substantially from the \$10.6 million incurred during 2010. The provision level for 2011 was just slightly below the \$2.2 million of net charge-offs incurred during the year.

RDSI continued to recover during 2011 from the significant losses incurred during 2010. While RDSI still suffered a net loss in 2011 (\$1.4 million), it was substantially improved from the \$14.0 million loss incurred during 2010. The 2011 results include a goodwill impairment of \$380,748, which reduced the RDSI goodwill and intangible value to zero. RDSI also incurred losses on assets that are no longer in use of \$608,585.

Competition

State Bank experiences significant competition in attracting depositors and borrowers. Competition in lending activities comes principally from other commercial banks in the lending areas of State Bank, and to a lesser extent, from savings associations, insurance companies, governmental agencies, credit unions, securities brokerage firms and pension funds. The primary factors in competing for loans are interest rates charged and overall banking services.

State Bank's competition for deposits comes from other commercial banks, savings associations, money market funds and credit unions as well as from insurance companies and securities brokerage firms. The primary factors in competing for deposits are interest rates paid on deposits, account liquidity and convenience of office location.

RDSI and DCM also operate in a highly competitive field. RDSI and DCM compete primarily on the basis of the value and quality of their item processing services and convenience to their customers.

RFS operates in the highly competitive trust services field and its competition consists primarily of other bank trust departments.

Supervision and Regulation

The following is a description of the significant statutes and regulations applicable to the Company and its subsidiaries. The description is qualified in its entirety by reference to the full text of the statutes, regulations and policies that are described. Also, such statutes, regulations and policies are continually under review by the U.S. Congress and state legislatures and federal and state regulatory agencies. A change in statutes, regulations or

regulatory policies applicable to the Company or its subsidiaries could have a material effect on our business.

Regulation of Bank Holding Companies and Their Subsidiaries in General

The Company is a bank holding company and, as such, is subject to regulation under the Bank Holding Company Act of 1956, as amended (the “Bank Holding Company Act”). The Bank Holding Company Act requires the prior approval of the Federal Reserve Board before a bank holding company may acquire direct or indirect ownership or control of more than 5% of the voting shares of any bank (unless the bank is already majority owned by the bank holding company), acquire all or substantially all of the assets of another bank or bank holding company, or merge or consolidate with any other bank holding company. Subject to certain exceptions, the Bank Holding Company Act also prohibits a bank holding company from acquiring 5% of the voting shares of any company that is not a bank and from engaging in any business other than banking or managing or controlling banks. The primary exception to this prohibition allows a bank holding company to own shares in any company the activities of which the Federal Reserve Board had determined, as of November 19, 1999, to be so closely related to banking as to be a proper incident thereto.

5.

The Company is subject to the reporting requirements of, and examination and regulation by, the Federal Reserve Board. The Federal Reserve Board has extensive enforcement authority over bank holding companies, including, without limitation, the ability to assess civil money penalties, issue cease and desist or removal orders, and require that a bank holding company divest subsidiaries, including its subsidiary banks. In general, the Federal Reserve Board may initiate enforcement actions for violations of laws and regulations and for unsafe or unsound practices. A bank holding company and its subsidiaries are prohibited from engaging in certain tying arrangements in connection with extensions of credit and/or the provision of other property or services to a customer by the bank holding company or its subsidiaries.

Under Federal Reserve Board policy, a bank holding company is expected to act as a source of financial strength to its subsidiary banks and to commit resources to support its subsidiary banks. Pursuant to this policy, the Federal Reserve Board may require a bank holding company to contribute additional capital to an undercapitalized subsidiary bank and may disapprove of the payment of dividends to shareholders if the Federal Reserve Board determines that the payment of such dividends would be an unsafe or unsound practice.

State Bank is a member of the Federal Reserve System, so its primary federal regulator is the Federal Reserve Board. The Federal Reserve Board issues regulations governing the operations of State Bank and examines State Bank. The Federal Reserve Board may initiate enforcement action against insured depository institutions and affiliated persons for violations of laws and regulations and for engaging in unsafe or unsound practices. The deposits of State Bank are insured by the Federal Deposit Insurance Corporation ("FDIC") and are subject to the applicable provisions of the Federal Deposit Insurance Act.

As a state-chartered bank incorporated under Ohio law, State Bank is also subject to regulation, supervision and examination by the Ohio Division of Financial Institutions (the "Division"). The Division may initiate supervisory measures or formal enforcement actions against Ohio state-chartered banks and, if the grounds provided by law exist, the Division may place an Ohio bank in conservatorship or receivership. Whenever the Division considers it necessary or appropriate, the Division may also examine the affairs of any holding company or any affiliate or subsidiary of an Ohio bank.

Various requirements and restrictions under the laws of the United States and the State of Ohio affect the operations of State Bank, including requirements to maintain reserves against deposits, restrictions on the nature and amount of loans which may be made and the interest that may be charged thereon, restrictions relating to investments and other activities, limitations on credit exposure to correspondent banks, limitations on activities based on capital and surplus, limitations on payment of dividends, and limitations on branching. Various consumer laws and regulations also affect the operations of State Bank.

The Federal Home Loan Banks ("FHLBs") provide credit to their members in the form of advances. As a member of the FHLB of Cincinnati, State Bank must maintain certain minimum investments in the capital stock of the FHLB of

Cincinnati State Bank was in compliance with these requirements at December 31, 2011.

6.

Dividends

On January 27, 2010, the Company announced that it had elected to suspend payment of quarterly cash dividends. There can be no assurance as to the amount of dividends which may be declared in future periods with respect to the common shares of the Company, since such dividends are subject to the discretion of the Company's Board of Directors, cash needs, general business conditions, dividends from the subsidiaries and applicable governmental regulations and policies.

The ability of the Company to obtain funds for the payment of dividends and for other cash requirements is largely dependent on the amount of dividends that may be declared by its subsidiaries. State Bank may not pay dividends to the Company if, after paying such dividends, it would fail to meet the required minimum levels under the risk-based capital guidelines and the minimum leverage ratio requirements. State Bank must obtain the approval of the Federal Reserve Board and the Ohio Division of Financial Institutions if a dividend in any year would cause the total dividends for that year to exceed the sum of the current year's net profits and the retained net profits for the preceding two years, less required transfers to surplus. At December 31, 2011, State Bank had \$2.2 million of excess earnings over the preceding three years.

Payment of dividends by State Bank may be restricted at any time at the discretion of the regulatory authorities, if they deem such dividends to constitute an unsafe and/or unsound banking practice. As of December 31, 2011 State Bank was required to obtain regulatory approval to pay dividends to the Company. In addition, the Company's deferral of interest on its trust preferred securities also prohibits payments of common stock dividends. These provisions could have the effect of limiting the Company's ability to pay dividends on its outstanding common shares. Moreover, the Federal Reserve Board expects the Company to serve as a source of strength to its subsidiary banks, which may require it to retain capital for further investment in the subsidiary, rather than for dividends to shareholders of the Company.

Transactions with Affiliates, Directors, Executive Officers and Shareholders

Sections 23A and 23B of the Federal Reserve Act and Federal Reserve Board Regulation W restrict transactions by banks and their subsidiaries with their affiliates. Any company or entity that controls, is controlled by or is under common control with a bank is generally considered to be an affiliate of the bank.

In general, Sections 23A and 23B and Regulation W:

limit the extent to which a bank or its subsidiaries may engage in "covered transactions" with any one affiliate to an amount equal to 10% of the bank's capital stock and surplus (i.e., tangible capital);

limit the extent to which a bank or its subsidiaries may engage in “covered transactions” with all affiliates to 20% of the bank’s capital stock and surplus; and
require that all covered transactions be on terms substantially the same, or at least as favorable to the bank or subsidiary, as those provided to nonaffiliated.

The term “covered transaction” includes the making of loans, purchase of assets, issuance of a guarantee and similar types of transactions.

A bank’s authority to extend credit to executive officers, directors and greater than 10% shareholders, as well as entities such persons control, is subject to Sections 22(g) and 22(h) of the Federal Reserve Act and Regulation O promulgated thereunder by the Federal Reserve Board. Among other things, these loans must be made on terms substantially the same as those offered to unaffiliated individuals (or be made under a benefit or compensation program and on terms widely available to employees) and must not involve a greater than normal risk of repayment. In addition, the amount of loans a bank may make to these persons is based, in part, on the bank’s capital position, and specified approval procedures must be followed in making loans which exceed specified amounts.

7.

Regulatory Capital

The Federal Reserve Board has adopted risk-based capital guidelines for bank holding companies and for state member banks, such as State Bank. The risk-based capital guidelines include both a definition of capital and a framework for calculating risk weighted assets by assigning assets and off-balance-sheet items to broad risk categories. The minimum ratio of total capital to risk weighted assets (including certain off-balance-sheet items, such as standby letters of credit) is 8%. Of that 8%, at least 4% must be comprised of common shareholders' equity (including retained earnings but excluding treasury stock), non-cumulative perpetual preferred stock, a limited amount of cumulative perpetual preferred stock, and minority interests in equity accounts of consolidated subsidiaries, less goodwill and certain other intangible assets ("Tier 1 capital"). The remainder of total risk-based capital ("Tier 2 capital") may consist, among other things, of certain amounts of mandatory convertible debt securities, subordinated debt, preferred stock not qualifying as Tier 1 capital, allowance for loan and lease losses and net unrealized gains, after applicable taxes, on available-for-sale equity securities with readily determinable fair values, all subject to limitations established by the guidelines. Under the guidelines, capital is compared to the relative risk related to the balance sheet. To derive the risk included in the balance sheet, one of four risk weights (0%, 20%, 50%, and 100%) is applied to different balance sheet and off-balance sheet assets, primarily based on the relative credit risk of the counterparty. The capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

The Federal Reserve Board also imposes a minimum leverage ratio (Tier 1 capital to total assets) of 3% for bank holding companies and state member banks that meet certain specified conditions, including no operational, financial or supervisory deficiencies, and including having the highest regulatory rating. The minimum leverage ratio is 1%-2% higher for other bank holding companies and state member banks based on their particular circumstances and risk profiles and those experiencing or anticipating significant growth. Failure to meet applicable capital guidelines could subject a banking institution to a variety of enforcement remedies available to federal and state regulatory authorities, including the termination of deposit insurance by the FDIC.

The federal banking regulators have established regulations governing prompt corrective action to resolve capital deficient banks. The regulations establish five capital level categories: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized. Under these regulations, institutions which become undercapitalized can become subject to mandatory regulatory scrutiny and limitations, which increase as capital decreases. Such institutions may also be required to file capital plans with their primary federal regulator, and their holding companies may be required to guarantee the capital shortfall up to 5% of the assets of the capital deficient institution at the time it becomes undercapitalized.

The Company's management believes that the Company and State Bank, at year end 2011, satisfied all requirements to be deemed "well capitalized".

Federal Deposit Insurance Corporation (“FDIC”)

The FDIC is an independent federal agency which insures the deposits of federally-insured banks and savings associations up to certain prescribed limits and safeguards the safety and soundness of financial institutions. State Bank’s deposits are subject to the deposit insurance assessments of the FDIC. Under the FDIC’s deposit insurance assessment system, the assessment rate for any insured institution may vary according to regulatory capital levels of the institution and other factors such as supervisory evaluations.

8.

The FDIC is authorized to prohibit any insured institution from engaging in any activity that poses a serious threat to the insurance fund and may initiate enforcement actions against a bank, after first giving the institution's primary regulatory authority an opportunity to take such action. The FDIC may also terminate the deposit insurance of any institution that has engaged in or is engaging in unsafe or unsound practices, is in an unsafe or unsound condition to continue operations or has violated any applicable law, order or condition imposed by the FDIC.

Monetary Policy and Economic Conditions

The commercial banking business is affected not only by general economic conditions, but also by the policies of various governmental regulatory authorities, including the Federal Reserve Board. The Federal Reserve Board regulates money and credit conditions and interest rates in order to influence general economic conditions primarily through open market operations in U.S. Government securities, changes in the discount rate on bank borrowings and changes in reserve requirements against bank deposits. These policies and regulations significantly affect the overall growth and distribution of bank loans, investments and deposits, and the interest rates charged on loans as well as the interest rates paid on deposits and accounts.

Holding Company Activities

In November 1999, the Gramm-Leach-Bliley Act was enacted, permitting bank holding companies to become financial holding companies and thereby affiliate with securities firms and insurance companies and engage in other activities that are financial in nature. A bank holding company may become a financial holding company if each of its subsidiary banks is well capitalized under the Federal Deposit Insurance Corporation Act of 1991 prompt corrective action provisions, is well managed, and has at least a satisfactory rating under the Community Reinvestment Act by filing a declaration that the bank holding company wishes to become a financial holding company. No regulatory approval is required for a financial holding company to acquire a company, other than a bank or savings association, engaged in activities that are financial in nature or incidental to activities that are financial in nature, as determined by the Federal Reserve Board.

The Gramm-Leach-Bliley Act defines "financial in nature" to include: (i) securities underwriting, dealing and market making; (ii) sponsoring mutual funds and investment companies; (iii) insurance underwriting and agency; (iv) merchant banking activities; and (v) activities that the Federal Reserve Board has determined to be closely related to banking.

The Company has not elected to become a financial holding company. The Company intends to continue to analyze the proposed advantages and disadvantages of becoming a financial holding company on a periodic basis.

SEC and NASDAQ Regulation

The Company is subject to the jurisdiction of the SEC and certain state securities authorities relating to the offering and sale of its securities. The Company is subject to the registration, reporting and other regulatory requirements of the Securities Act of 1933, as amended, and the Securities Exchange Act of 1934, as amended (the “Exchange Act”), and the rules adopted by the SEC under those acts. The Company’s common shares are listed on The NASDAQ Global Market under the symbol “RBNF”, and the Company is subject to the rules and regulations of The NASDAQ Stock Market, Inc. (“NASDAQ”) applicable to listed companies.

9.

Sarbanes-Oxley Act of 2002 and Related Rules Affecting Corporate Governance

As mandated by the Sarbanes-Oxley Act of 2002 (“SOX”), the SEC has adopted rules and regulations governing, among other matters, corporate governance, auditing and accounting, executive compensation, and enhanced the timely disclosure of corporate information. The SEC has also approved corporate governance rules promulgated by NASDAQ. The Board of Directors of the Company has taken a series of actions to comply with the NASDAQ and SEC rules and to further strengthen its corporate governance practices. The Company has adopted and implemented a Code of Conduct and Ethics and a copy of that policy can be found on the Company’s website at www.rurbanfinancial.net by first clicking “Corporate Governance” and then “Code of Conduct”. The Company has also adopted charters of the Audit Committee, the Compensation Committee and the Governance and Nominating Committee, which charters are available on the Company’s website at www.rurbanfinancial.net by first clicking “Corporate Governance” and then “Supplementary Info”.

USA Patriot Act

The Uniting and Strengthening of America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (the “Patriot Act”) gives the United States Government greater powers over financial institutions to combat money laundering and terrorist access to the financial system in our country. The Patriot Act requires regulated financial institutions to establish programs for obtaining identifying information from customers seeking to open new accounts and establish enhanced due diligence policies, procedures and controls designed to detect and report suspicious activity.

Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”) was enacted into law on July 21, 2010. The Dodd-Frank Act is significantly changing the regulation of financial institutions and the financial services industry. Because the Dodd-Frank Act requires various federal agencies to adopt a broad range of regulations with significant discretion, many of the details of the new law and the effects they will have on the Company will not be known for months and even years.

Among the provisions already implemented pursuant to the Dodd-Frank Act, the following provisions have or may have an effect on the business of the Corporation and its subsidiaries:

a new Consumer Financial Protection Bureau has been formed with broad powers to adopt and enforce consumer protection regulations;

the federal law prohibiting the payment of interest on commercial demand deposit accounts was eliminated effective in July 2011;

the standard maximum amount of deposit insurance per customer was permanently increased to \$250,000 and non-interest-bearing transaction accounts have unlimited insurance through December 31, 2012;

the assessment base for determining deposit insurance premiums has been expanded from domestic deposits to average assets minus average tangible equity; and

public companies in all industries are or will be required to provide shareholders the opportunity to cast a non-binding advisory vote on executive compensation.

Additional provisions not yet implemented that may have an effect on the Company and its subsidiaries include the following:

new capital regulations for bank holding companies will be adopted, which may impose stricter requirements, and any new trust preferred securities issued after May 19, 2010 will no longer constitute Tier I capital; and

10.

new corporate governance requirements applicable generally to all public companies in all industries will require new compensation practices and disclosure requirements, including requiring companies to “claw back” incentive compensation under certain circumstances, to consider the independence of compensation advisors and to make additional disclosures in proxy statements with respect to compensation matters.

Many provisions of the Dodd-Frank Act have not yet been implemented and will require interpretation and rule making by federal regulators. As a result, the ultimate effect of the Dodd-Frank Act on the Company cannot yet be determined. However, it is likely that the implementation of these provisions will increase compliance costs and fees paid to regulators, along with possibly restricting the operations of the Company and its subsidiaries.

Effect of Environmental Regulation

Compliance with federal, state and local provisions regulating the discharge of materials into the environment, or otherwise relating to the protection of the environment, has not had a material effect upon the capital expenditures, earnings or competitive position of the Company and its subsidiaries. The Company believes that the nature of the operations of its subsidiaries has little, if any, environmental impact. The Company, therefore, anticipates no material capital expenditures for environmental control facilities for its current fiscal year or for the foreseeable future. The Company's subsidiaries may be required to make capital expenditures for environmental control facilities related to properties which they may acquire through foreclosure proceedings in the future; however, the amount of such capital expenditures, if any, is not currently determinable.

Available Information

The Company will provide, without charge, to each shareholder, upon written request to Rurban Financial Corp., P.O. Box 467, Defiance, Ohio 43512, Attention: Linda Sickmiller, Investor Relations Department, a copy of the Company's Annual Report on Form 10-K, including the Financial Statements and Schedules thereto required to be filed with the SEC, for the Company's most recent fiscal year.

The Company maintains an Internet website at www.rurbanfinancial.net (this uniform resource locator, or URL, is an inactive textual reference only and is not intended to incorporate the Company's website into this Annual Report on Form 10-K). The Company makes available free of charge on or through its Internet website the Company's annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act, as well as the Company's definitive proxy statements filed pursuant to Section 14 of the Exchange Act, as soon as reasonably practicable after the Company electronically files such material with, or furnishes such material to, the SEC.

Item 1A. Risk Factors

Cautionary Statement Regarding Forward-Looking Information

Certain statements contained in this Annual Report on Form 10-K, and in other statements that we make from time to time in filings by the Company with the SEC, in press releases, and in oral and written statements made by or with the approval of the Company which are not statements of historical fact constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Examples of forward-looking statements include: (a) projections of income or expense, earnings per share, the payment or non-payment of dividends, capital structure and other financial items; (b) statements of plans and objectives of the Company or our Board of Directors or management, including those relating to products and services; (c) statements of future economic performance; (d) statements of future customer attraction or retention; and (d) statements of assumptions underlying these statements. These forward-looking statements include, but are not limited to, statements preceded by or that include the words or phrases “anticipates”, “believes”, “plans”, “intends”, “expects”, “projects”, “estimates”, “should”, “may”, “would be”, “will all result”, “will continue”, “will remain”, or similar expressions.

11.

The Private Securities Litigation Reform Act of 1995 provides a “safe harbor” for forward-looking statements to encourage companies to provide prospective information so long as those statements are identified as forward-looking and are accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those discussed in the forward-looking statements. We desire to take advantage of the “safe harbor” provisions of the Act.

Forward-looking statements involve risks and uncertainties. Actual results may differ materially from those predicted by the forward-looking statements because of various factors and possible events, including those factors identified below. There is also the risk that the Company’s management or Board of Directors incorrectly analyzes these risks and forces, or that the strategies the Company develops to address them are unsuccessful.

Forward-looking statements speak only as of that date on which they are made. Except as may be required by law, the Company undertakes no obligation to update any forward-looking statement to reflect events or circumstances after the date on which the statement is made to reflect unanticipated events.

All forward-looking statements attributable to the Company or any person acting on our behalf are qualified in their entirety by the following cautionary statements.

Changes in economic conditions could adversely affect our earnings, as our borrowers’ ability to repay loans and the value of the collateral securing our loans decline.

Our success depends to a large extent upon local and national economic conditions, as well as governmental fiscal and monetary policies. Conditions such as inflation, recession, unemployment, changes in interest rates, money supply and other factors beyond our control can adversely affect our asset quality, deposit levels and loan demand and, therefore, our earnings and our capital. Because we have a significant amount of real estate loans, additional decreases in real estate values could adversely affect the value of property used as collateral and our ability to sell the collateral upon foreclosure. Adverse changes in the economy may also have a negative effect on the ability of our borrowers to make timely repayments of their loans, which would have an adverse impact on our earnings and cash flows.

We continue to experience difficult economic conditions and high unemployment in our market areas, which has impaired the ability of our customers to make payments on their loans, and a significant continued decline in the economy in our market areas could have a materially adverse effect on our financial condition and results of operations. As a result of these economic conditions, the Company’s future earnings continue to be susceptible to further declining credit conditions in the markets in which we operate.

Our earnings are significantly affected by the fiscal and monetary policies of the federal government and its agencies.

The policies of the Federal Reserve Board impact us significantly. The Federal Reserve Board regulates the supply of money and credit in the United States. Its policies directly and indirectly influence the rate of interest earned on loans and paid on borrowings and interest-bearing deposits, and can also affect the value of financial instruments we hold. Those policies determine to a significant extent our cost of funds for lending and investing. Changes in those policies are beyond our control and are difficult to predict. Federal Reserve Board policies can also affect our borrowers, potentially increasing the risk that they may fail to repay their loans. For example, a tightening of the money supply by the Federal Reserve Board could reduce the demand for a borrower's products and services. This could adversely affect the borrower's earnings and ability to repay its loan, which could have a material adverse effect on our financial condition and results of operations.

12.

Changes in interest rates could have a material adverse effect on our financial condition and results of operations.

Our earnings depend substantially on our interest spread, which is the difference between the rates we earn on loans, securities and other earning assets and the interest rates we pay on deposits and other borrowings. These rates will depend on many factors that are partly or entirely outside of our control, including general economic conditions and the policies of various governmental and regulatory authorities. While we have taken measures intended to manage the risks of operating in a changing rate environment, there can be no assurance that such measures will be effective in avoiding undue interest rate risk. As market interest rates rise, we will have competitive pressures to increase the rates we pay on deposits, which will result in a decrease in net interest income and could have a material adverse effect on our financial condition and results of operations.

If our actual loan losses exceed our allowance for loan losses, our net income will decrease.

Our loan customers may not repay their loans according to their terms, and the collateral securing the payment of these loans may be insufficient to pay any remaining loan balance. We may experience significant loan losses, which could have a material adverse effect on our operating results. In accordance with accounting principles generally accepted in the United States, we maintain an allowance for loan losses to provide for loan defaults and non-performance, which when combined, we refer to as the allowance for loan losses. Our allowance for loan losses may not be adequate to cover actual credit losses, and future provisions for credit losses could have a material adverse effect on our operating results. Our allowance for loan losses is based on prior experience, as well as an evaluation of the risks in the current portfolio. The amount of future losses is susceptible to changes in economic, operating and other conditions, including changes in interest rates that may be beyond our control, and these losses may exceed current estimates. Federal regulatory agencies, as an integral part of their examination process, review our loans and allowance for loan losses. We cannot assure you that we will not further increase the allowance for loan losses or that regulators will not require us to increase this allowance. Either of these occurrences could have a material adverse effect on our financial condition and results of operations.

RDSI may continue to experience net operating losses as a result of the loss of customers.

On March 9, 2011, Rurban Financial Corp. (“Rurban”) and its wholly-owned nonbank data services subsidiary, Rurbanc Data Services, Inc., dba RDSI Banking Systems (“RDSI”), entered into a Consent Order (the “Consent Order”) with the Federal Reserve Board that directs RDSI to take certain actions to strengthen its financial condition and operations. Rurban’s banking subsidiary, The State Bank and Trust Company, is not a party to the Consent Order.

The Consent Order specifies, among other conditions, that RDSI must strengthen board oversight of critical areas of operations, maintain appropriate capital levels, strengthen working capital management, and modify its strategic plan

to improve earnings. While the Consent Order remains in effect, RDSI is prohibited from declaring or paying any dividends to Rurban without the prior approval of the Federal Reserve Board, and Rurban is prohibited from making any capital investments in or loans to RDSI without the prior approval of the Federal Reserve Board.

The existence of this consent order inhibits the ability of RDSI to secure new clients as well as to retain existing clients.

13.

FDIC insurance premiums may increase materially, which could negatively affect our profitability.

The FDIC insures deposits at FDIC insured financial institutions, including State Bank. The FDIC charges the insured financial institutions premiums to maintain the Deposit Insurance Fund at a certain level. During 2008 and 2009, there were higher levels of bank failures which dramatically increased resolution costs of the FDIC and depleted the deposit insurance fund. The FDIC collected a special assessment in 2009 to replenish the Deposit Insurance Fund and also required a prepayment of an estimated amount of future deposit insurance premiums. If the costs of future bank failures increase, deposit insurance premiums may also increase.

Legislative or regulatory changes could adversely impact our businesses.

The financial services industry is extensively regulated. We are subject to state and federal regulation, supervision and legislation that govern almost all aspects of our operations. Laws and regulations may change from time to time and are primarily intended for the protection of consumers, depositors, federal deposit insurance funds and the banking system as a whole, and not to benefit our shareholders. The impact of any changes to laws and regulations or other actions by regulatory agencies may negatively impact us. In light of current conditions in the global financial markets and the global economy, regulators have increased their focus on the regulation of the financial services industry. Most recently, the federal government has intervened on an unprecedented scale in responding to the stresses experienced in the global financial markets. Some of the laws enacted by Congress and regulations promulgated by the federal banking regulators subject us and other financial institutions to additional restrictions, oversight or costs that may have an impact on our business, results of operations or the price of our common shares.

The Dodd-Frank Act may adversely impact our results of operations and financial condition.

On July 21, 2010, the Dodd-Frank Act was signed into law. The Dodd-Frank Act represents a comprehensive overhaul of the financial services industry within the United States. There are a number of reform provisions that are likely to significantly impact the ways in which banks and bank holding companies, including the Corporation and the Bank, do business. Many provisions of the Dodd-Frank Act will not be implemented immediately and will require interpretation and rule making by federal regulators. The Company is closely monitoring all relevant sections of the Dodd-Frank Act to ensure continued compliance with laws and regulations. While the ultimate effect of the Dodd-Frank Act on the Company and its subsidiaries cannot currently be determined, the law and its implemented rules and regulations are likely to result in increased compliance costs and fees paid to regulators, along with possible restrictions on the operations of the Company and its subsidiaries, all of which may have a material adverse effect on the Company's operating results and financial condition.

We may be a defendant from time to time in a variety of litigation and other actions, which could have a material adverse effect on our financial condition and results of operations.

The Company and its subsidiaries may be involved from time to time in a variety of litigation arising out of our businesses. The risk of litigation increases in times of increased troubled loan collection activity. Our insurance may not cover all claims that may be asserted against us, and any claims asserted against us, regardless of merit or eventual outcome, may harm our reputation. Should the ultimate judgments or settlements in any litigation exceed our insurance coverage, they could have a material adverse effect on our financial condition and results of operations. In addition, we may not be able to obtain appropriate types or levels of insurance in the future, nor may we be able to obtain adequate replacement policies with acceptable terms, if at all.

Our success depends upon our ability to attract and retain key personnel.

Our success depends upon the continued service of our senior management team and upon our ability to attract and retain qualified financial services personnel. Competition for qualified employees is intense. We cannot assure you that we will be able to retain our existing key personnel or attract additional qualified personnel. If we lose the services of our key personnel, or are unable to attract additional qualified personnel, our business, financial condition and results of operations could be adversely affected.

We depend upon the accuracy and completeness of information about customers.

In deciding whether to extend credit or enter into other transactions with customers, we may rely on information provided to us by customers, including financial statements and other financial information. We may also rely on representations of customers as to the accuracy and completeness of that information and, with respect to financial statements, on reports of independent auditors. For example, in deciding whether to extend credit to a business, we may assume that the customer's audited financial statements conform with generally accepted accounting principles and present fairly, in all material respects, the financial condition, results of operations and cash flows of the customer, and we may also rely on the audit report covering those financial statements. Our financial condition and results of operations could be negatively impacted to the extent we rely on financial statements that do not comply with generally accepted accounting principles or that are materially misleading.

Our ability to pay cash dividends is limited, and we may be unable to pay cash dividends in the future even if we elect to do so.

We are dependent primarily upon the earnings of our operating subsidiaries for funds to pay dividends on our common shares. The payment of dividends by us is also subject to regulatory restrictions. As a result, any payment of dividends in the future will be dependent, in large part, on our ability to satisfy these regulatory restrictions and our subsidiaries' earnings, capital requirements, financial condition and other factors. In January 2010, the Company announced the suspension of quarterly cash dividends. There can be no assurance as to if or when the Company might be able to pay dividends again or as to the amount of any dividends which may be declared and paid to shareholders in future periods. Our continued failure to pay dividends on our common shares could have a material adverse effect on the market price of our common shares.

A limited trading market exists for our common shares which could lead to price volatility.

Your ability to sell or purchase our common shares depends upon the existence of an active trading market for our common shares. While our stock is quoted on the NASDAQ Global Market, it trades infrequently. As a result, you may be unable to sell or purchase our common shares at the volume, price and time you desire. The limited trading market for our common shares may cause fluctuations in the market value of our common shares to be exaggerated, leading to price volatility in excess of that which would occur in a more active trading market.

The preparation of our financial statements requires the use of estimates that may vary from actual results.

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the U.S. requires management to make significant estimates that affect the financial statements. Two of our most critical estimates are the level of the allowance for loan losses and the accounting for goodwill and other intangibles. Because of the inherent nature of these estimates, we cannot provide complete assurance that we will not be required to charge earnings for significant unexpected loan losses, nor that we will not recognize a material provision for impairment of our goodwill. For additional information regarding these critical estimates, see Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations beginning on page 33 of this Annual Report on Form 10-K.

15.

Changes in accounting standards could impact our results of operations.

The accounting standard setters, including the Financial Accounting Standards Board, the SEC and other regulatory bodies, periodically change the financial accounting and reporting standards that govern the preparation of our consolidated financial statements. These changes can be difficult to predict and can materially affect how we record and report our financial condition and results of operations. In some cases, we could be required to apply a new or revised standard retroactively, which would result in the restatement of our financial statements for prior periods.

Our information systems may experience an interruption or security breach.

We rely heavily on communications and information systems to conduct our business. Any failure, interruption or breach in security of these systems could result in failures or disruptions in our customer relationship management, general ledger, deposit, loan and other systems. While we have policies and procedures designed to prevent or limit the effect of the possible failure, interruption or security breach of our information systems, there can be no assurance that any such failure, interruption or security breach will not occur or, if they do occur, that they will be adequately addressed. The occurrence of any failure, interruption or security breach of our information systems could damage our reputation, result in a loss of customer business, subject us to additional regulatory scrutiny, or expose us to civil litigation and possible financial liability.

We may elect or be compelled to seek additional capital in the future, but capital may not be available when it is needed.

We are required by federal and state regulatory authorities to maintain adequate levels of capital to support our operations. In addition, we may elect to raise additional capital to support our business or to finance acquisitions, if any, or we may otherwise elect to raise additional capital. In that regard, a number of financial institutions have recently raised considerable amounts of capital as a result of deterioration in their results of operations and financial condition arising from the turmoil in the mortgage loan market, deteriorating economic conditions, declines in real estate values and other factors, which may diminish our ability to raise additional capital. Our ability to raise additional capital, if needed, will depend on conditions in the capital markets, economic conditions and a number of other factors, many of which are outside our control, and on our financial performance. Accordingly, we cannot be assured of our ability to raise additional capital if needed or on terms acceptable to us. If we cannot raise additional capital if and when needed, it may have a material adverse effect on our financial condition, results of operations and prospects.

Item 1B. Unresolved Staff Comments

None

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Item 2. Properties.

The Company's principal executive offices are located at 401 Clinton Street, Defiance, Ohio. This facility is owned by State Bank, and a portion of the facility is leased to the Company. State Bank owns the land and buildings occupied by 18 of its banking centers and leases five other properties used as banking centers and office space from various parties on varying lease terms. There is no outstanding mortgage debt on any of the properties which the Company owns. Listed below are the banking centers, loan production offices and service facilities of the Company and their addresses, all of which are located in Allen, Defiance, Fulton, Franklin, Lucas, Paulding, Williams and Wood Counties of Ohio, and Allen and Steuben Counties of Indiana:

Main Banking Center & Corporate Offices	401 Clinton Street, Defiance, OH
Angola LPO	908 North Wayne Street, Suite A, Angola, IN
Bryan Banking Center	1419 West High Street, Bryan, OH
Chief Banking Center	705 Deatrick Street, Defiance, OH
Columbus LPO	109 South High, Dublin, OH
Delta Banking Center	312 Main Street, Delta, OH
Fort Wayne Banking Center	12832 Coldwater Road, Fort Wayne, IN
Luckey Banking Center	235 Main Street, Luckey, OH
Lyons Banking Center	133 East Morenci Street, Lyons, OH
Market Street Banking Center	930 West Market Street, Lima, OH
Montpelier Banking Center	1201 East Main Street, Montpelier, OH
Motor Bank Drive-thru	510 Third Street, Defiance, OH
Northtowne Banking Center	1600 North Clinton Street, Defiance, OH
Oakwood Banking Center	218 North First Street, Oakwood, OH
Paulding Banking Center	220 North Main Street, Paulding, OH
Perrysburg Banking Center	610 East South Boundary Street, Perrysburg, OH
Pioneer Banking Center	119 South State Street, Pioneer, OH
Sylvania Banking Center	6401 Monroe Street, Sylvania, OH
Walbridge Banking Center	311 Main Street, Walbridge, OH
Wauseon Banking Center	515 Parkview, Wauseon, OH
West Unity Banking Center	112 East Jackson Street, West Unity, OH

The State Bank and Trust Company has entered into an operating lease with Remax Reality for various office storage. RDSI leases office space located at 7622 St Rt. 66, Defiance, Ohio, office space located at 104 Depot Street, Archbold, Ohio and office space located at 105 East Holland Street, Archbold, Ohio. RDSI (DCM) leases office space located at 3101 Technology Blvd., Suite B, Lansing, Michigan.

Item 3. Legal Proceedings.

On January 18, 2011, the Company's subsidiary, RDSI, filed a lawsuit against New Core Holdings, Inc. ("New Core") in the Court of Common Pleas, Defiance County, Ohio (Case No. 11-CV-41125). RDSI's complaint alleges, among other things, that New Core breached its loan agreement, promissory notes, merger agreement and certain other agreements entered into between RDSI and New Core in connection with the previously planned merger of RDSI with New Core. RDSI's complaint seeks, among other things, recovery of an amount in excess of \$3,260,000, plus costs and expenses, including attorneys' fees, an order directing the release of certain software collateral, and a declaration that RDSI has no obligation to advance any additional loans or pay any additional funds to New Core. New Core subsequently removed this lawsuit to the United States District Court for the Northern District of Ohio (Case No. 3:11cv366). New Core filed an answer to the complaint on October 14, 2011. On December 30, 2011, New Core filed an amended answer and counterclaims alleging that RDSI breached the merger agreement and certain other agreements and also breached its fiduciary duties to New Core. At this time, the Company is unable to predict the likelihood of RDSI's success on its claims, or the amount of any damages that may be awarded to RDSI or New Core in this lawsuit.

In the ordinary course of our business, the Company and its subsidiaries are also parties to various legal actions which we believe are incidental to the operation of our business. Although the ultimate outcome and amount of liability, if any, with respect to these legal actions cannot presently be ascertained with certainty, in the opinion of management, based upon information currently available to us, any resulting liability is not likely to have a material adverse effect on the Company's consolidated financial position, results of operations or cash flows.

Item 4. Mine Safety Disclosures.

Not Applicable

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Supplemental Item: Executive Officers of the Registrant.

The following table lists the names and ages of the executive officers of the Company as of March 30, 2012, the positions presently held by each executive officer and the business experience of each executive officer during the past five years. Unless otherwise indicated, each person has held his principal occupation(s) for more than five years.

Name	Age	Position(s) Held with the Company and its Subsidiaries and Principal Occupation(s)
Mark A. Klein	57	President, and Chief Executive Officer of the Company since January 2010; Director of the Company since February 2010; President and Chief Executive Officer of State Bank since January 2006; Director of State Bank since 2006; President of RDSI since October 2011; Member of RFS Investment Committee since March 2007. Senior Vice President Private Banking of Sky Bank, Toledo, Ohio from 2004 to January 2006; Vice President and Team Leader of Sky Bank, Toledo, Ohio from 2000 to 2004; Executive Vice President and Senior Lender of \$450 million Sky Bank affiliate from 1994 to 1999; 12 year Member of Defiance City School Board of Education; Member of Defiance Area Foundation Board (non-profit); Member of Promedica-Defiance Regional Medical Center Foundation Board.
Anthony V. Cosentino	50	Executive Vice President and Chief Financial Officer of the Company and State Bank since March 2010; Chief Financial Officer of RDSI since October 2011; Member of RFS Investment Committee since 2010. Vice President for Financial Planning and Analysis at AmTrust Financial Corporation from June 2006 to December 2009. Chief Financial Officer of Fifth Third Bank of Northeastern Ohio, a subsidiary of Fifth Third Bancorp, from August 1994 to May 2006.
Jonathan R. Gathman	38	Executive Vice President and Senior Lending Officer of the Company since October 2005; Senior Vice President and Commercial Lending Manager from June 2005 through October 2005; Vice President and Commercial Lender from February 2003 through June 2005. Began working for The State Bank and Trust Company in May 1996.

Statistical Financial Information Regarding the Company

The following schedules and tables analyze certain elements of the consolidated balance sheets and statements of income of the Company and its subsidiaries, as required under Exchange Act Industry Guide 3 promulgated by the SEC, and should be read in conjunction with the narrative analysis presented in Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations and the Consolidated Financial Statements of the Company and its subsidiaries incorporated herein by reference from the Company's 2011 Annual Report.

**I. DISTRIBUTION OF ASSETS, LIABILITIES AND SHAREHOLDERS' EQUITY;
INTEREST RATES AND INTEREST DIFFERENTIAL**

The following are the condensed average balance sheets for the years ending December 31 and the interest earned or paid on such amounts and the average interest rate thereon:

(\$in thousands)	2011			2010			2009		
	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate
Assets:									
Securities									
Taxable	\$97,528	\$2,010	2.06 %	\$86,961	\$2,267	2.61 %	\$89,092	\$4,083	4.58 %
Non-taxable (1)	21,892	1,483	6.77 %	31,895	2,114	6.63 %	27,114	1,611	5.94 %
Federal funds sold	219	1	0.25 %	-	-	N/A	77	0	0.17 %
Loans, net (2)(3)	438,383	24,558	5.60 %	445,700	25,934	5.82 %	453,787	27,492	6.06 %
Total earning assets	558,022	28,052	5.03 %	564,556	30,315	5.37 %	570,070	33,186	5.82 %
Cash and due from banks	26,477			43,024			27,573		
Allowance for loan losses	(6,534)			(6,913)			(5,650)		
Premises and equipment	16,797			20,336			23,993		
Other assets	48,766			52,777			51,485		
Total assets	\$643,528			\$673,781			\$667,470		
Liabilities									
Deposits									
Savings and interest-bearing demand deposits	\$234,497	\$368	0.16 %	\$231,294	\$622	0.27 %	\$209,394	\$780	0.37 %
Time deposits	217,546	3,614	1.66 %	215,668	4,501	2.09 %	226,275	5,747	2.54 %
Short-term borrowings	31,307	912	2.91 %	50,092	1,851	3.70 %	46,930	1,869	3.98 %
Advances from FHLB	15,674	402	2.57 %	28,313	1,094	3.86 %	38,571	1,625	4.21 %
Junior subordinated debentures	20,620	1,406	6.82 %	20,620	1,534	7.44 %	20,620	1,573	7.63 %
Other borrowed funds	3,085	96	3.12 %	-	-	N/A	-	-	N/A
Total interest-bearing liabilities	522,728	6,798	1.30 %	545,987	9,602	1.76 %	541,790	11,594	2.14 %
Demand deposits	64,239			62,821			53,857		

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Other liabilities	9,526	7,693	8,246
Total liabilities	596,493	616,500	603,894
Shareholders' equity	47,035	57,281	63,576
Total liabilities and shareholders' equity	\$643,528	\$673,781	\$667,470
Net interest income (tax equivalent basis)	\$21,253	\$20,713	\$21,592
Net interest income as a percent of average interest-earning assets	3.81 %	3.67 %	3.79 %

(1) Security interest is computed on a tax equivalent basis using a 34% statutory tax rate. The tax equivalent adjustment was \$504,000, \$719,000 and \$548,000 in 2011, 2010 and 2009, respectively.

(2) Nonaccruing loans and loans held for sale are included in the average balances.

(3) Loan interest is computed on a tax equivalent basis using a 34% statutory tax rate. The tax equivalent adjustment was \$38,000, \$32,000 and \$47,000 in 2011, 2010 and 2009, respectively.

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**I. DISTRIBUTION OF ASSETS, LIABILITIES AND SHAREHOLDERS' EQUITY;
INTEREST RATES AND INTEREST DIFFERENTIAL (Continued)**

The following tables set forth the effect of volume and rate changes on interest income and expense for the periods indicated. For purposes of these tables, changes in interest due to volume and rate were determined as follows:

Volume Variance - change in volume multiplied by the previous year's rate.

Rate Variance - change in rate multiplied by the previous year's volume.

Rate/Volume Variance - change in volume multiplied by the change in rate. This variance was allocated to volume variance and rate variance in proportion to the relationship of the absolute dollar amount of the change in each.

Interest on non-taxable securities has been adjusted to a fully tax equivalent basis using a statutory tax rate of 34% in 2011, 2010 and 2009.

	Total Variance	Variance Attributable To	
	2011/2010	Volume	Rate
	(dollars in thousands)		
Interest income			
Securities			
Taxable	\$(257)	\$254	\$(511)
Non-taxable	(631)	(677)	46
Federal funds sold	1	1	-
Loans, net of unearned income and deferred loan fees	(1,376)	(421)	(955)
	(2,263)	(843)	(1,420)
Interest expense			
Deposits			
Savings and interest-bearing demand deposits	(255)	8	