NBT BANCORP INC
Form 10-Q
August 11, 2014

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 June 30, 2014.

OR

o 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 0-14703

NBT BANCORP INC.
(Exact Name of Registrant as Specified in its Charter)

DELAWARE	16-1268674
(State of Incorporation)	(I.R.S. Employer Identification No.)

52 SOUTH BROAD STREET, NORWICH, NEW YORK 13815
(Address of Principal Executive Offices) (Zip Code)

Registrant's Telephone Number, Including Area Code: (607) 337-2265

None
(Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report)

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 o

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 (Section 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No o

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. (Check One):

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

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

As of July 31, 2014, there were 43,704,282 shares outstanding of the Registrant's common stock, $0.01 par value per share.

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PART I FINANCIAL INFORMATION

Item 1 – FINANCIAL STATEMENTS

NBT Bancorp Inc. and Subsidiaries
Consolidated Balance Sheets (unaudited)

(In thousands, except share and per share data)	June 30, 2014	December 31, 2013
Assets		
Cash and due from banks	$178,539	$157,625
Short-term interest bearing accounts	4,798	1,301
Securities available for sale, at fair value	1,378,799	1,364,881
Securities held to maturity (fair value $123,376 and $113,276, respectively)	125,965	117,283
Trading securities	7,355	5,779
Federal Reserve and Federal Home Loan Bank stock	49,093	46,864
Loans	5,574,488	5,406,795
Less allowance for loan losses	69,534	69,434
Net loans	5,504,954	5,337,361
Premises and equipment, net	87,972	88,327
Goodwill	263,634	264,997
Intangible assets, net	22,819	25,557
Bank owned life insurance	116,007	114,966
Other assets	129,577	127,234
Total assets	$7,869,512	$7,652,175
Liabilities		
Demand (noninterest bearing)	$1,676,246	$1,645,641
Savings, NOW, and money market	3,363,911	3,223,441
Time	1,002,431	1,021,142
Total deposits	6,042,588	5,890,224
Short-term borrowings	534,478	456,042
Long-term debt	251,125	308,823
Junior subordinated debt	101,196	101,196
Other liabilities	82,984	79,321
Total liabilities	7,012,371	6,835,606
Stockholders' equity		
Preferred stock, $0.01 par value. Authorized 2,500,000 shares at June 30, 2014 and December 31, 2013	-	-
Common stock, $0.01 par value. Authorized 100,000,000 shares at June 30, 2014 and December 31, 2013; issued 49,651,494 at June 30, 2014 and December 31, 2013	497	497
Additional paid-in-capital	574,002	574,152
Retained earnings	413,011	385,787
Accumulated other comprehensive loss	(6,555)	(16,765)
Common stock in treasury, at cost, 5,952,696 and 6,138,444 shares at June 30, 2014 and December 31, 2013, respectively	(123,814)	(127,102)
Total stockholders' equity	857,141	816,569
Total liabilities and stockholders' equity	$7,869,512	$7,652,175

See accompanying notes to unaudited interim consolidated financial statements.

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NBT Bancorp Inc. and Subsidiaries Consolidated Statements of Income (unaudited) (In thousands, except per share data)	Three months ended June 30, 2014	 2013	Six months ended June 30, 2014	 2013
Interest, fee, and dividend income				
Interest and fees on loans	$60,559	$62,031	$120,574	$115,726
Securities available for sale	6,612	6,537	13,369	12,283
Securities held to maturity	783	548	1,551	1,073
Other	502	488	1,039	891
Total interest, fee, and dividend income	68,456	69,604	136,533	129,973
Interest expense				
Deposits	3,000	4,296	6,284	8,446
Short-term borrowings	209	67	440	109
Long-term debt	2,135	3,026	4,642	6,635
Junior subordinated debt	538	560	1,076	988
Total interest expense	5,882	7,949	12,442	16,178
Net interest income	62,574	61,655	124,091	113,795
Provision for loan losses	4,166	6,402	7,762	12,060
Net interest income after provision for loan losses	58,408	55,253	116,329	101,735
Noninterest income				
Insurance and other financial services revenue	5,594	5,755	12,331	12,648
Service charges on deposit accounts	4,397	4,933	8,766	9,256
ATM and debit card fees	4,357	4,044	8,429	7,286
Retirement plan administration fees	2,977	2,957	5,895	5,639
Trust	4,953	4,699	9,399	7,612
Bank owned life insurance	978	886	2,360	1,735
Net securities gains (losses)	14	(61)	21	1,084
Gain on the sale of equity investment	19,401	-	19,401	-
Other	3,356	2,324	5,702	5,506
Total noninterest income	46,027	25,537	72,304	50,766
Noninterest expense				
Salaries and employee benefits	31,142	29,160	60,676	56,207
Occupancy	5,435	5,219	11,661	10,196
Data processing and communications	4,015	3,854	8,016	7,309
Professional fees and outside services	3,752	3,237	7,167	6,138
Equipment	3,132	2,910	6,248	5,492
Office supplies and postage	1,803	1,656	3,488	3,246
FDIC expenses	1,229	1,273	2,507	2,403
Advertising	726	1,000	1,465	1,723
Amortization of intangible assets	1,236	1,351	2,546	2,202
Loan collection and other real estate owned	801	421	1,841	1,139
Merger expenses	-	1,269	-	11,950
Prepayment penalties on long-term debt	4,554	-	4,554	-
Other	4,911	5,100	10,084	9,150
Total noninterest expense	62,736	56,450	120,253	117,155
Income before income tax expense	41,699	24,340	68,380	35,346
Income tax expense	14,059	7,424	22,731	10,781
Net income	$27,640	$16,916	$45,649	$24,565
Earnings per share				
Basic	$0.63	$0.39	$1.04	$0.61

Diluted	$0.62	$0.38	$1.03	$0.61

See accompanying notes to unaudited interim consolidated financial statements.

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NBT Bancorp Inc. and Subsidiaries Consolidated Statements of Comprehensive Income (unaudited) (In thousands)	Three months ended June 30, 2014	2013	Six months ended June 30, 2014	2013
Net income	$27,640	$16,916	$45,649	$24,565
Other comprehensive income (loss), net of tax				
Unrealized net holding gains (losses) arising during the period (pre-tax amounts of $8,267, ($24,712), $16,892 and ($26,464))	4,992	(14,923)	10,200	(15,978)
Reclassification adjustment for net gains related to securities available for sale included in net income (pre-tax amounts of $14, ($61), $21 and $1,084)	(8)	37	(13)	(650)
Pension and other benefits:				
Amortization of prior service cost and actuarial gains (pre-tax amounts of $19, $710, $38 and $1,536)	11	426	23	922
Total other comprehensive income (loss)	4,995	(14,460)	10,210	(15,706)
Comprehensive income	$32,635	$2,456	$55,859	$8,859

See accompanying notes to unaudited interim consolidated financial statements

NBT Bancorp Inc. and Subsidiaries
Consolidated Statements of Stockholders' Equity (unaudited)

(in thousands, except share and per share data)	Common Stock	Additional Paid-in-Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Common Stock in Treasury	Total
Balance at December 31, 2012	$ 393	$ 346,692	$ 357,558	$ (5,880)	$ (116,490)	$ 582,273
Net income	-	-	24,565	-	-	24,565
Cash dividends - $0.40 per share	-	-	(15,568)	-	-	(15,568)
Purchase of 267,425 treasury shares	-	-	-	-	(5,460)	(5,460)
Issuance of 10,346,363 shares, net of 408,957treasury shares, for acquisition	104	225,447	-	-	(5,779)	219,772
Net issuance of 89,338 shares to employee benefit plans and other stock plans, including tax benefit	-	(2,506)	-	-	1,479	(1,027)
Stock-based compensation	-	2,726	-	-	-	2,726
Other comprehensive loss	-	-	-	(15,706)	-	(15,706)
Balance at June 30, 2013	$ 497	$ 572,359	$ 366,555	$ (21,586)	$ (126,250)	$ 791,575
Balance at December 31, 2013	$ 497	$ 574,152	$ 385,787	$ (16,765)	$ (127,102)	$ 816,569
Net income	-	-	45,649	-	-	45,649
Cash dividends - $0.42 per share	-	-	(18,425)	-	-	(18,425)
Purchase of 3,288 treasury shares	-	-	-	-	(72)	(72)
Net issuance of 189,036 shares to employee benefit plans and other stock plans, including tax benefit	-	(2,232)	-	-	3,360	1,128
Stock-based compensation	-	2,082	-	-	-	2,082
Other comprehensive income	-	-	-	10,210	-	10,210
Balance at June 30, 2014	$ 497	$ 574,002	$ 413,011	$ (6,555)	$ (123,814)	$ 857,141

See accompanying notes to unaudited interim consolidated financial statements.

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NBT Bancorp Inc. and Subsidiaries Consolidated Statements of Cash Flows (unaudited) (In thousands, except per share data)	Six Months Ended June 30, 2014	2013
Operating activities		
Net income	$45,649	$24,565
Adjustments to reconcile net income to net cash provided by operating activities		
Provision for loan losses	7,762	12,060
Depreciation and amortization of premises and equipment	4,105	3,828
Net accretion on securities	1,883	2,811
Amortization of intangible assets	2,546	2,202
Stock based compensation	2,082	2,726
Increase in surrender value of bank owned life insurance	(1,392)	(1,735)
Purchases of trading securities	(1,485)	(949)
Unrealized (gains) losses in trading securities	(91)	(225)
Deferred income tax benefit	(1,654)	(519)
Proceeds from sales of loans held for sale	1,922	39,060
Originations and purchases of loans held for sale	(3,701)	(40,233)
Net gains on sales of loans held for sale	(3)	(817)
Net security gains	(21)	(1,084)
Net gain on sales of other real estate owned	(212)	(571)
Gains on bank owned life insurance settlement	(414)	-
Gain on sale of equity investment	(19,401)	-
Prepayment penalties on long-term debt	4,554	-
Net decrease in other assets	9,261	9,144
Net decrease in other liabilities	(8,421)	(8,333)
Net cash provided by operating activities	42,969	41,930
Investing activities		
Net cash used in acquisitions	-	80,909
Securities available for sale:		
Proceeds from maturities, calls, and principal paydowns	119,680	234,543
Proceeds from sales	-	26,236
Purchases	(116,594)	(219,000)
Securities held to maturity:		
Proceeds from maturities, calls, and principal paydowns	14,835	16,822
Purchases	(17,363)	(71,988)
Proceeds from FHLB stock redemption	37,179	-
Purchases of Federal Reserve and FHLB stock	(39,408)	(5,584)
Net increase in loans	(174,358)	(119,872)
Proceeds from settlement of bank owned life insurance	765	-
Purchases of premises and equipment	(3,498)	(2,272)
Proceeds from sales of other real estate owned	1,919	2,122
Proceeds from the sale of equity investment	19,639	-
Net cash used in investing activities	(157,204)	(58,084)
Financing activities		
Net increase (decrease) in deposits	152,364	(19,593)
Net increase in short-term borrowings	78,436	201,066
Issuance of long-term debt	120,000	-
Repayments of long-term debt	(194,785)	(163,307)
Proceeds from the issuance of shares to employee benefit plans and other stock plans	1,128	(965)

Purchase of treasury stock	(72)	(5,460)
Cash dividends and payment for fractional shares	(18,425)	(15,568)
Net cash provided by (used in) financing activities	138,646	(3,827)
Net increase (decrease) in cash and cash equivalents	24,411	(19,981)
Cash and cash equivalents at beginning of period	158,926	163,668
Cash and cash equivalents at end of period	$ 183,337	$ 143,687

See accompanying notes to unaudited interim consolidated financial statements.

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Supplemental disclosure of cash flow information	Six Months Ended June 30,	
Cash paid during the period for:	2014	2013
Interest	$13,405	$16,853
Income taxes paid	19,496	4,525
Noncash investing activities:		
Loans transferred to other real estate owned	$785	$3,031
Acquisitions:		
Fair value of assets acquired	$-	$1,503,810
Fair value of liabilities assumed	-	1,284,038

See accompanying notes to unaudited interim consolidated financial statements.

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NBT BANCORP INC. and Subsidiaries
NOTES TO UNAUDITED INTERIM CONSOLIDATED FINANCIAL STATEMENTS
June 30, 2014

Note 1. Description of Business

NBT Bancorp Inc. (the “Registrant” or the “Company”) is a registered financial holding company incorporated in the state of Delaware in 1986, with its principal headquarters located in Norwich, New York. The principal assets of the Registrant consist of all of the outstanding shares of common stock of its subsidiaries, including: NBT Bank, National Association (the “Bank”), NBT Financial Services, Inc. (“NBT Financial”), NBT Holdings, Inc. (“NBT Holdings”), Hathaway Agency, Inc., and CNBF Capital Trust I, NBT Statutory Trust I and NBT Statutory Trust II (collectively, the “Trusts”). The Company’s principal sources of revenue are the management fees and dividends it receives from the Bank, NBT Financial and NBT Holdings.

The Company’s business, primarily conducted through the Bank but also through its other subsidiaries, consists of providing commercial banking and financial services to customers in its market area, which includes central and upstate New York, northeastern Pennsylvania, southern New Hampshire, western Massachusetts and the greater Burlington, Vermont area. The Company has been, and intends to continue to be, a community-oriented financial institution offering a variety of financial services. The Company’s business philosophy is to operate as a community bank with local decision-making, principally in non-metropolitan markets, providing a broad array of banking and financial services to retail, commercial, and municipal customers.

Note 2. Basis of Presentation

The accompanying unaudited interim consolidated financial statements include the accounts of the Registrant and its wholly owned subsidiaries, the Bank, NBT Financial and NBT Holdings. Collectively, the Registrant and its subsidiaries are referred to herein as “the Company.” The interim data includes all adjustments, consisting only of normal recurring adjustments, necessary for a fair statement of the results for the interim periods in accordance with generally accepted accounting principles (“GAAP”). These consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in our 2013 Annual Report on Form 10-K. The results of operations for the interim periods are not necessarily indicative of the results that may be expected for the full year or any other interim period. All intercompany transactions have been eliminated in consolidation. Amounts in the prior period financial statements are reclassified whenever necessary to conform to current period presentation. The Company has evaluated subsequent events for potential recognition and/or disclosure and there were none identified.

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Note 3. Securities

The amortized cost, estimated fair value, and unrealized gains and losses of securities available for sale are as follows:

(In thousands)	Amortized cost	Unrealized gains	Unrealized losses	Estimated fair value
June 30, 2014				
U.S. Treasury	$33,129	$ 195	$ -	$33,324
Federal Agency	310,181	478	3,518	307,141
State & municipal	103,253	2,267	172	105,348
Mortgage-backed:				
Government-sponsored enterprises	368,988	8,473	428	377,033
U.S. government agency securities	19,527	921	94	20,354
Collateralized mortgage obligations:				
Government-sponsored enterprises	480,694	2,315	11,816	471,193
U.S. government agency securities	48,065	610	59	48,616
Other securities	12,962	3,025	197	15,790
Total securities available for sale	$1,376,799	$ 18,284	$ 16,284	$1,378,799
December 31, 2013				
U.S. Treasury	$43,279	$ 337	$ -	$43,616
Federal Agency	285,880	343	7,308	278,915
State & municipal	113,435	1,842	1,612	113,665
Mortgage-backed:				
Government-sponsored enterprises	337,666	5,788	2,131	341,323
U.S. government agency securities	21,924	1,002	85	22,841
Collateralized mortgage obligations:				
Government-sponsored enterprises	521,257	1,777	18,141	504,893
U.S. government agency securities	43,943	794	102	44,635
Other securities	12,367	2,854	228	14,993
Total securities available for sale	$1,379,751	$ 14,737	$ 29,607	$1,364,881

Other securities primarily represent marketable equity securities.

There were no sales of securities available for sale during the six months ended June 30, 2014. Proceeds from the sales of securities available for sale were $26.2 million during the six months ended June 30, 2013, and gains on the sales were $1.1 million.

Securities with amortized costs totaling $1.4 billion at June 30, 2014 and $1.4 billion at December 31, 2013 were pledged to secure public deposits and for other purposes required or permitted by law. At June 30, 2014 and December 31, 2013, securities with an amortized cost of $225.9 million and $218.4 million, respectively, were pledged as collateral for securities sold under repurchase agreements.

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The amortized cost, estimated fair value, and unrealized gains and losses of securities held to maturity are as follows:

(In thousands)	Amortized cost	Unrealized gains	Unrealized losses	Estimated fair value
June 30, 2014				
Mortgage-backed	$ 853	$ 125	$ -	$ 978
Collateralized mortgage obligations	59,792	-	3,139	56,653
State & municipal	65,320	425	-	65,745
Total securities held to maturity	$ 125,965	$ 550	$ 3,139	$ 123,376
December 31, 2013				
Mortgage-backed	$ 953	$ 128	$ -	$ 1,081
Collateralized mortgage obligations	62,025	-	4,569	57,456
State & municipal	54,305	442	8	54,739
Total securities held to maturity	$ 117,283	$ 570	$ 4,577	$ 113,276

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The following table sets forth information with regard to investment securities with unrealized losses at June 30, 2014 and December 31, 2013:

	Less than 12 months			12 months or longer			Total		
Security Type:	Fair Value	Unrealized losses	Number of Positions	Fair Value	Unrealized losses	Number of Positions	Fair Value	Unrealized losses	Number of Positions
June 30, 2014 Investment securities available for sale:									
Federal agency	$14,584	(17)	2	$227,183	$(3,501)	19	$241,767	$(3,518)	21
State & municipal	8,256	(22)	28	20,416	(150)	70	28,672	(172)	98
Mortgage-backed	1,523	(6)	12	49,695	(516)	36	51,218	(522)	48
Collateralized mortgage obligations	89,915	(542)	12	269,579	(11,333)	23	359,494	(11,875)	35
Other securities	2,553	(34)	1	3,191	(163)	2	5,744	(197)	3
Total securities with unrealized losses	$116,831	$(621)	55	$570,064	$(15,663)	150	$686,895	$(16,284)	205
June 30, 2014 Investment securities held to maturity:									
Collateralized mortgage obligations	56,653	(3,139)	5	-	-	-	$56,653	(3,139)	5
December 31, 2013 Investment securities available for sale:									
Federal agency	$233,935	$(6,927)	20	$9,619	$(381)	1	$243,554	$(7,308)	21
State & municipal	50,328	(1,612)	177	-	-	-	50,328	(1,612)	177
Mortgage-backed	143,080	(2,216)	79	-	-	-	143,080	(2,216)	79
Collateralized mortgage obligations	379,273	(18,243)	36	-	-	-	379,273	(18,243)	36
Other securities	5,490	(203)	2	223	(25)	1	5,713	(228)	3
Total securities with unrealized losses	$812,106	$(29,201)	314	$9,842	$(406)	2	$821,948	$(29,607)	316
December 31, 2013 Investment securities held to maturity:									
Collateralized mortgage obligations	$57,456	$(4,569)	5	$-	$-	-	$57,456	$(4,569)	5
State & municipal	1,012	(8)	1	-	-	-	1,012	(8)	1
Total securities with unrealized losses	$58,468	$(4,577)	6	$-	$-	-	$58,468	$(4,577)	6

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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 or in other comprehensive income, depending on whether the Company 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 the Company 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, the other-than-temporary impairment 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 the Company 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 credit loss, the other-than-temporary impairment shall be separated into (a) the amount representing the credit loss and (b) the amount related to all other factors. The amount of the total other-than-temporary impairment related to the credit loss shall be recognized in earnings. The amount of the total other-than-temporary impairment related to other factors shall be recognized in other comprehensive income, net of applicable taxes.

In estimating other-than-temporary impairment losses, management considers, among other things, (i) the length of time and the extent to which the fair value has been less than cost, (ii) the financial condition and near-term prospects of the issuer, and (iii) the historical and implied volatility of the fair value of the security.

Management has the intent to hold the securities classified as held to maturity until they mature, at which time it is believed the Company will receive full value for the securities. Furthermore, as of June 30, 2014, management also had the intent to hold, and will not be required to sell, the securities classified as available for sale for a period of time sufficient for a recovery of cost, which may be until maturity. The unrealized losses are due to increases in market interest rates over the yields available at the time the underlying securities were purchased. When necessary, the Company has performed a discounted cash flow analysis to determine whether or not it will receive the contractual principal and interest on certain securities. The fair value is expected to recover as the bonds approach their maturity date or repricing date or if market yields for such investments decline. As of June 30, 2014, management believes the impairments detailed in the table above are temporary and no other-than-temporary impairment losses have been realized in the Company's consolidated statements of income.

The following tables set forth information with regard to contractual maturities of debt securities at June 30, 2014:

(In thousands)	Amortized cost	Estimated fair value
Debt securities classified as available for sale		
Within one year	$29,964	$30,109
From one to five years	359,226	358,895
From five to ten years	215,602	220,020
After ten years	759,045	753,985
	$1,363,837	$1,363,009
Debt securities classified as held to maturity		
Within one year	$30,983	$31,083
From one to five years	17,462	17,651
From five to ten years	15,636	15,772
After ten years	61,884	58,870
	$125,965	$123,376

Maturities of mortgage-backed, collateralized mortgage obligations and asset-backed securities are stated based on their estimated average lives. Actual maturities may differ from estimated average lives or contractual maturities because, in certain cases, borrowers have the right to call or prepay obligations with or without call or prepayment penalties.

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Except for U.S. Government securities, there were no holdings, when taken in the aggregate, of any single issuer that exceeded 10% of consolidated stockholders' equity at June 30, 2014.

Note 4. Allowance for Loan Losses and Credit Quality of Loans

Allowance for Loan Losses

The allowance for loan losses is maintained at a level estimated by management to provide adequately for risk of probable losses inherent in the current loan portfolio. The adequacy of the allowance for loan losses is continuously monitored. It is assessed for adequacy using a methodology designed to ensure the level of the allowance reasonably reflects the loan portfolio's risk profile. It is evaluated to ensure that it is sufficient to absorb all reasonably estimable credit losses inherent in the current loan portfolio.

To develop and document a systematic methodology for determining the allowance for loan losses, the Company has divided the loan portfolio into three segments, each with different risk characteristics and methodologies for assessing risk. Those segments are further segregated between our loans accounted for under the amortized cost method (referred to as "originated" loans) and loans acquired in a business combination (referred to as "acquired" loans). Each portfolio segment is broken down into class segments where appropriate. Class segments contain unique measurement attributes, risk characteristics and methods for monitoring and assessing risk that are necessary to develop the allowance for loan losses. Unique characteristics such as borrower type, loan type, collateral type, and risk characteristics define each class segment. The following table illustrates the portfolio and class segments for the Company's loan portfolio:

Portfolio	Class
Commercial Loans	Commercial
	Commercial Real Estate
	Agricultural
	Agricultural Real Estate
	Business Banking
Consumer Loans	Indirect
	Home Equity
	Direct
Residential Real Estate Mortgages	

Commercial Loans

The Company offers a variety of commercial loan products including commercial (non-real estate), commercial real estate, agricultural, agricultural real estate, and business banking loans. The Company's underwriting analysis for commercial loans typically includes credit verification, independent appraisals, a review of the borrower's financial condition, and a detailed analysis of the borrower's underlying cash flows.

Commercial – The Company offers a variety of loan options to meet the specific needs of our commercial customers including term loans, time notes and lines of credit. Such loans are made available to businesses for working capital needs such as inventory and receivables, business expansion and equipment purchases. Generally, a collateral lien is placed on equipment or other assets owned by the borrower. These loans carry a higher risk than commercial real estate loans due to the nature of the underlying collateral, which can be business assets such as equipment and accounts receivable. To reduce the risk, management also attempts to secure real estate as collateral and obtain personal guarantees of the borrowers.

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Commercial Real Estate – The Company offers commercial real estate loans to finance real estate purchases, refinancings, expansions and improvements to commercial properties. Commercial real estate loans are made to finance the purchases of real estate, generally with completed structures. These commercial real estate loans are secured by first liens on the real estate, which may include apartments, commercial structures, housing businesses, healthcare facilities, and other non owner-occupied facilities. These loans are typically less risky than commercial loans, since they are secured by real estate and buildings, and are generally originated in amounts of no more than 80% of the appraised value of the property.

Agricultural – The Company offers a variety of agricultural loans to meet the needs of our agricultural customers including term loans, time notes, and lines of credit. These loans are made to purchase livestock, purchase and modernize equipment, and finance seasonal crop expenses. Generally, a collateral lien is placed on the livestock, equipment, produce inventories, and/or receivables owned by the borrower. These loans may carry a higher risk than commercial and agricultural real estate loans due to the industry price volatility, and in some cases, the perishable nature of the underlying collateral. To reduce these risks, management may attempt to secure these loans with additional real estate collateral, obtain personal guarantees of the borrowers, or obtain government loan guarantees to provide further support.

Agricultural Real Estate – The Company offers real estate loans to our agricultural customers to finance farm related real estate purchases, refinancings, expansions, and improvements to agricultural properties such as barns, production facilities, and land. The agricultural real estate loans are secured by first liens on the farm real estate. Because they are secured by land and buildings, these loans may be less risky than agricultural loans. These loans are typically originated in amounts of no more than 75% of the appraised value of the property. Government loan guarantees may be obtained to provide further support.

Business Banking - The Company offers a variety of loan options to meet the specific needs of our business banking customers including term loans, business banking mortgages and lines of credit. Such loans are generally less than $0.5 million and are made available to businesses for working capital such as inventory and receivables, business expansion, equipment purchases, and agricultural needs. Generally, a collateral lien is placed on equipment or other assets owned by the borrower such as inventory and/or receivables. These loans carry a higher risk than commercial loans due to the smaller size of the borrower and lower levels of capital. To reduce the risk, the Company obtains personal guarantees of the owners for a majority of the loans.

Consumer Loans

The Company offers a variety of consumer loan products including indirect, home equity, and direct loans.

Indirect – The Company maintains relationships with many dealers primarily in the communities that we serve. Through these relationships, the company primarily finances the purchases of automobiles and recreational vehicles (such as campers, boats, etc.) indirectly through dealer relationships. Approximately 75% of the indirect relationships represent automobile financing. Most of these loans carry a fixed rate of interest with principal repayment terms typically ranging from three to six years, based upon the nature of the collateral and the size of the loan. The majority of indirect consumer loans are underwritten on a secured basis using the underlying collateral being financed.

Home Equity – The Company offers fixed home equity loans as well as home equity lines of credit to consumers to finance home improvements, debt consolidation, education and other uses. Consumers are able to borrow up to 85% of the equity in their homes. The Company originates home equity lines of credit and second mortgage loans (loans secured by a second junior lien position on one-to-four-family residential real estate). These loans carry a higher risk than first mortgage residential loans as they are in a second position with respect to collateral. Risk is reduced through underwriting criteria, which include credit verification, appraisals, a review of the borrower's financial condition, and personal cash flows. A security interest, with title insurance when necessary, is taken in the underlying real estate.

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Direct – The Company offers a variety of consumer installment loans to finance vehicle purchases, mobile home purchases and personal expenditures. Most of these loans carry a fixed rate of interest with principal repayment terms typically ranging from one to ten years, based upon the nature of the collateral and the size of the loan. The majority of consumer loans are underwritten on a secured basis using the underlying collateral being financed or a customer's deposit account. In addition to installment loans, the Company also offers personal lines of credit and overdraft protection. A minimal amount of loans are unsecured, which carry a higher risk of loss.

Residential Real Estate Mortgages

Residential real estate loans consist primarily of loans secured by first or second deeds of trust on primary residences. We originate adjustable-rate and fixed-rate, one-to-four-family residential real estate loans for the construction, purchase or refinancing of a mortgage. These loans are collateralized by owner-occupied properties located in the Company's market area. Loans on one-to-four-family residential real estate are generally originated in amounts of no more than 85% of the purchase price or appraised value (whichever is lower), or have private mortgage insurance. The Company's underwriting analysis for residential mortgage loans typically includes credit verification, independent appraisals, and a review of the borrower's financial condition. Mortgage title insurance and hazard insurance are normally required. Construction loans have a unique risk, because they are secured by an incomplete dwelling. This risk is reduced through periodic site inspections, including one at each loan draw period.

For purposes of evaluating the adequacy of the allowance, the Company considers a number of significant factors that affect the collectability of the portfolio. For individually analyzed loans, these include estimates of loss exposure, which reflect the facts and circumstances that affect the likelihood of repayment of such loans as of the evaluation date. For homogeneous pools of loans, estimates of the Company's exposure to credit loss reflect a current assessment of a number of factors, which could affect collectability. These factors include: past loss experience; size, trend, composition, and nature of loans; changes in lending policies and procedures, including underwriting standards and collection, charge-offs and recoveries; trends experienced in nonperforming and delinquent loans; current economic conditions in the Company's market; portfolio concentrations that may affect loss experienced across one or more components of the portfolio; the effect of external factors such as competition, legal and regulatory requirements; and the experience, ability, and depth of lending management and staff. In addition, various regulatory agencies, as an integral component of their examination process, periodically review the Company's allowance for loan losses. Such agencies may require the Company to make loan grade changes as well as recognize additions to the allowance based on their examinations.

After a thorough consideration of the factors discussed above, any required additions or reductions to the allowance for loan losses are made periodically by charges or credits to the provision for loan losses. These charges or credits are necessary to maintain the allowance at a level which management believes is reasonably reflective of overall inherent risk of probable loss in the portfolio. While management uses available information to recognize losses on loans, additions and reductions of the allowance may fluctuate from one reporting period to another. These fluctuations are reflective of changes in risk associated with portfolio content and/or changes in management's assessment of any or all of the determining factors discussed above.

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The following tables illustrate the changes in the allowance for loan losses by our portfolio segments for the three and six months ended June 30, 2014 and 2013:

Three months ended June 30	Commercial Loans	Consumer Loans	Residential Real Estate Mortgages	Unallocated	Total
Balance as of March 31, 2014	$ 34,437	$ 28,436	$ 6,225	$ 336	$ 69,434
Charge-offs	(1,427)	(3,648)	(165)	-	(5,240)
Recoveries	314	714	146	-	1,174
Provision	1,799	2,471	(1)	(103)	4,166
Ending Balance as of June 30, 2014	$ 35,123	$ 27,973	$ 6,205	$ 233	$ 69,534
Balance as of March 31, 2013	$ 35,358	$ 26,285	$ 6,708	$ 383	$ 68,734
Charge-offs	(1,198)	(3,653)	(302)	-	(5,153)
Recoveries	416	696	89	-	1,201
Provision	3,128	3,128	311	(165)	6,402
Ending Balance as of June 30, 2013	$ 37,704	$ 26,456	$ 6,806	$ 218	$ 71,184

Six months ended June 30,	Commercial Loans	Consumer Loans	Residential Real Estate Mortgages	Unallocated	Total
Balance as of December 31, 2013	$ 35,090	$ 27,694	$ 6,520	$ 130	$ 69,434
Charge-offs	(1,906)	(7,680)	(484)	-	(10,070)
Recoveries	713	1,455	240	-	2,408
Provision	1,226	6,504	(71)	103	7,762
Ending Balance as of June 30, 2014	$ 35,123	$ 27,973	$ 6,205	$ 233	$ 69,534
Balance as of December 31, 2012	$ 35,624	$ 27,162	$ 6,252	$ 296	$ 69,334
Charge-offs	(4,520)	(7,376)	(973)	-	(12,869)
Recoveries	883	1,673	103	-	2,659
Provision	5,717	4,997	1,424	(78)	12,060
Ending Balance as of June 30, 2013	$ 37,704	$ 26,456	$ 6,806	$ 218	$ 71,184

For acquired loans, to the extent that we experience deterioration in borrower credit quality resulting in a decrease in our expected cash flows subsequent to acquisition of the loans, an allowance for loan losses would be established based on our estimate of future credit losses over the remaining life of the loans. As of June 30, 2014, included in the above tables, there was $1.5 million in the allowance for loan losses related to an acquired commercial loan. There was no allowance as of June 30, 2013 related to acquired loans. Net charge-offs related to acquired loans totaled approximately $0.1 million and $0.2 million during the three months ended June 30, 2014 and 2013, respectively, and are included in the table above. Net charge-offs related to acquired loans totaled approximately $0.2 million and $0.4 million during the six months ended June 30, 2014 and 2013, respectively, and are included in the table above.

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The following tables illustrate the allowance for loan losses and the recorded investment by portfolio segments as of June 30, 2014 and December 31, 2013:

Allowance for Loan Losses and Recorded Investment in Loans
(in thousands)

	Commercial Loans	Consumer Loans	Residential Real Estate Mortgages	Unallocated	Total
As of June 30, 2014					
Allowance for loan losses	$35,123	$27,973	$6,205	$ 233	$69,534
Allowance for loans individually evaluated for impairment	2,100	-	-		2,100
Allowance for loans collectively evaluated for impairment	$33,023	$27,973	$6,205	$ 233	$67,434
Ending balance of loans	$2,476,246	$2,025,035	$1,073,207		$5,574,488
Ending balance of originated loans individually evaluated for impairment	13,874	5,600	2,738		22,212
Ending balance of acquired loans individually evaluated for impairment	9,672	-	-		9,672
Ending balance of acquired loans collectively evaluated for impairment	367,818	179,253	289,405		836,476
Ending balance of originated loans collectively evaluated for impairment	$2,084,882	$1,840,182	$781,064		$4,706,128
As of December 31, 2013					
Allowance for loan losses	$35,090	$27,694	$6,520	$ 130	$69,434
Allowance for loans individually evaluated for impairment	715	-	-		715
Allowance for loans collectively evaluated for impairment	$34,375	$27,694	$6,520	$ 130	$68,719
Ending balance of loans	$2,392,621	$1,972,537	$1,041,637		$5,406,795
Ending balance of originated loans individually evaluated for impairment	16,120	3,248	2,012		21,380
Ending balance of acquired loans individually evaluated for impairment	10,060	-	-		10,060
Ending balance of acquired loans collectively evaluated for impairment	392,329	219,587	308,416		920,332
Ending balance of originated loans collectively evaluated for impairment	$1,974,112	$1,749,702	$731,209		$4,455,023

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Credit Quality of Loans

Loans are placed on nonaccrual status when timely collection of principal and interest in accordance with contractual terms is doubtful. Loans are transferred to nonaccrual status generally when principal or interest payments become ninety days delinquent, unless the loan is well secured and in the process of collection, or sooner when management concludes or circumstances indicate that borrowers may be unable to meet contractual principal or interest payments. When a loan is transferred to a nonaccrual status, all interest previously accrued in the current period but not collected is reversed against interest income in that period. Interest accrued in a prior period and not collected is charged-off against the allowance for loan losses. The Company's nonaccrual policies are the same for all classes of financing receivable.

If ultimate repayment of a nonaccrual loan is expected, any payments received are applied in accordance with contractual terms. If ultimate repayment of principal is not expected, any payment received on a nonaccrual loan is applied to principal until ultimate repayment becomes expected. Nonaccrual loans are returned to accrual status when they become current as to principal and interest and demonstrate a period of performance under the contractual terms and, in the opinion of management, are fully collectible as to principal and interest. When in the opinion of management the collection of principal appears unlikely, the loan balance is charged-off in total or in part. For loans in all portfolios, the principal amount is charged off in full or in part as soon as management determines, based on available facts, that the collection of principal in full is improbable. For commercial loans, management considers specific facts and circumstances relative to individual credits in making such a determination. For consumer and residential loan classes, management uses specific guidance and thresholds from the Federal Financial Institutions Examination Council's Uniform Retail Credit Classification and Account Management Policy.

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The following table illustrates the Company's nonaccrual loans by loan class:

Loans on Nonaccrual Status as of:

(In thousands)	June 30, 2014	December 31, 2013
ORIGINATED		
Commercial Loans		
Commercial	$3,885	$ 3,669
Commercial Real Estate	6,616	7,834
Agricultural	1,343	1,135
Agricultural Real Estate	1,590	961
Business Banking	6,008	5,701
	19,442	19,300
Consumer Loans		
Indirect	1,359	1,461
Home Equity	7,772	5,931
Direct	67	86
	9,198	7,478
Residential Real Estate Mortgages	7,711	7,105
	$36,351	$ 33,883
ACQUIRED		
Commercial Loans		
Commercial	$6,339	$ 6,599
Commercial Real Estate	3,429	3,559
Business Banking	954	1,340
	10,722	11,498
Consumer Loans		
Indirect	118	93
Home Equity	514	570
Direct	31	49
	663	712
Residential Real Estate Mortgages	3,498	3,872
	$14,883	$ 16,082
TOTAL NONACCRUAL LOANS	$51,234	$ 49,965

The following tables set forth information with regard to past due and nonperforming loans by loan class as of June 30, 2014 and December 31, 2013:

Age Analysis of Past Due Financing Receivables
As of June 30, 2014
(in thousands)

	31-60 Days Past Due Accruing	61-90 Days Past Due Accruing	Greater Than 90 Days Past Due Accruing	Total Past Due Accruing	Non-Accrual	Current	Recorded Total Loans
ORIGINATED							
Commercial Loans							
Commercial	$ 53	$ -	$ -	$ 53	$ 3,885	$ 653,268	$ 657,206
Commercial Real Estate	-	-	-	-	6,616	994,773	1,001,389
Agricultural	170	-	-	170	1,343	55,572	57,085
Agricultural Real Estate	4	-	-	4	1,590	40,768	42,362
Business Banking	869	451	-	1,320	6,008	333,386	340,714
	1,096	451	-	1,547	19,442	2,077,767	2,098,756
Consumer Loans							
Indirect	12,444	2,015	1,100	15,559	1,359	1,265,140	1,282,058
Home Equity	4,470	995	839	6,304	7,772	494,123	508,199
Direct	529	138	27	694	67	54,764	55,525
	17,443	3,148	1,966	22,557	9,198	1,814,027	1,845,782
Residential Real Estate							
Mortgages	3,082	594	119	3,795	7,711	772,296	783,802
	$ 21,621	$ 4,193	$ 2,085	$ 27,899	$ 36,351	$ 4,664,090	$ 4,728,340
ACQUIRED							
Commercial Loans							
Commercial	$ 14	$ -	$ -	$ 14	$ 6,339	92,335	$ 98,688
Commercial Real Estate	582	-	-	582	3,429	210,204	214,215
Business Banking	441	-	-	441	954	63,192	64,587
	1,037	-	-	1,037	10,722	365,731	377,490
Consumer Loans							
Indirect	481	114	54	649	118	91,212	91,979
Home Equity	370	204	36	610	514	80,068	81,192
Direct	73	6	11	90	31	5,961	6,082
	924	324	101	1,349	663	177,241	179,253
Residential Real Estate							
Mortgages	1,317	-	-	1,317	3,498	284,590	289,405
	$ 3,278	$ 324	$ 101	$ 3,703	$ 14,883	$ 827,562	$ 846,148
Total Loans	$ 24,899	$ 4,517	$ 2,186	$ 31,602	$ 51,234	$ 5,491,652	$ 5,574,488

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Age Analysis of Past Due Financing Receivables
As of December 31, 2013
(in thousands)

	31-60 Days Past Due Accruing	61-90 Days Past Due Accruing	Greater Than 90 Days Past Due Accruing	Total Past Due Accruing	Non-Accrual	Current	Recorded Total Loans
ORIGINATED							
Commercial Loans							
Commercial	$ 105	$ 247	$ -	$ 352	$ 3,669	$ 612,402	$ 616,423
Commercial Real Estate	1,366	-	-	1,366	7,834	925,116	934,316
Agricultural	150	21	-	171	1,135	63,856	65,162
Agricultural Real Estate	519	-	-	519	961	35,172	36,652
Business Banking	1,228	122	105	1,455	5,701	330,523	337,679
	3,368	390	105	3,863	19,300	1,967,069	1,990,232
Consumer Loans							
Indirect	14,093	2,878	1,583	18,554	1,461	1,141,829	1,161,844
Home Equity	6,033	1,888	1,115	9,036	5,931	517,856	532,823
Direct	679	125	46	850	86	57,347	58,283
	20,805	4,891	2,744	28,440	7,478	1,717,032	1,752,950
Residential Real Estate Mortgages	3,951	379	808	5,138	7,105	720,978	733,221
	$ 28,124	$ 5,660	$ 3,657	$ 37,441	$ 33,883	$ 4,405,079	$ 4,476,403
ACQUIRED							
Commercial Loans							
Commercial	$ 24	$ -	$ -	$ 24	$ 6,599	$ 96,603	$ 103,226
Commercial Real Estate	-	-	-	-	3,559	225,455	229,014
Business Banking	320	2	-	322	1,340	68,487	70,149
	344	2	-	346	11,498	390,545	402,389
Consumer Loans							
Indirect	939	113	71	1,123	93	123,870	125,086
Home Equity	753	63	-	816	570	85,690	87,076
Direct	76	56	9	141	49	7,235	7,425
	1,768	232	80	2,080	712	216,795	219,587
Residential Real Estate Mortgages	1,725	-	-	1,725	3,872	302,819	308,416
	$ 3,837	$ 234	$ 80	$ 4,151	$ 16,082	$ 910,159	$ 930,392
Total Loans	$ 31,961	$ 5,894	$ 3,737	$ 41,592	$ 49,965	$ 5,315,238	$ 5,406,795

There were no material commitments to extend further credit to borrowers with nonperforming loans.

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Impaired Loans

The methodology used to establish the allowance for loan losses on impaired loans incorporates specific allocations on loans analyzed individually. Classified and nonperforming loans with outstanding balances of $0.5 million or more and all troubled debt restructured loans ("TDR") are evaluated for impairment through the Company's quarterly status review process. In determining that we will be unable to collect all principal and interest payments due in accordance with the contractual terms of the loan agreements, we consider factors such as payment history and changes in the financial condition of individual borrowers, local economic conditions, historical loss experience and the conditions of the various markets in which the collateral may be liquidated. For loans that are impaired as defined by accounting standards, impairment is measured by one of three methods: 1) the fair value of collateral less cost to sell, 2) present value of expected future cash flows or 3) the loan's observable market price. All impaired loans are reviewed on a quarterly basis for changes in the measurement of impairment. Any change to the previously recognized impairment loss is recognized as a change to the allowance account and recorded in the consolidated statement of income as a component of the provision for loan losses.

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The following table provides information on loans specifically evaluated for impairment as of June 30, 2014 and December 31, 2013:

(in thousands)	June 30, 2014 Recorded Investment Balance (Book)	June 30, 2014 Unpaid Principal Balance (Legal)	June 30, 2014 Related Allowance	December 31, 2013 Recorded Investment Balance (Book)	December 31, 2013 Unpaid Principal Balance (Legal)	December 31, 2013 Related Allowance
ORIGINATED						
With no related allowance recorded:						
Commercial Loans						
Commercial	$2,000	$2,096		$4,721	$4,777	
Commercial Real Estate	6,854	7,823		4,613	5,164	
Agricultural	119	189		125	195	
Agricultural Real Estate	1,406	1,697		1,431	1,708	
Business Banking	702	1,094		210	602	
Total Commercial Loans	11,081	12,899		11,100	12,446	
Consumer Loans						
Home Equity	5,600	6,031		3,248	3,472	
Residential Real Estate Mortgages	2,738	3,073		2,012	2,255	
Total	19,419	22,003		16,360	18,173	
With an allowance recorded:						
Commercial Loans						
Commercial Real Estate	2,793	4,649	600	5,020	6,877	715
ACQUIRED						
With no related allowance recorded:						
Commercial Loans						
Commercial	-	-		6,501	6,538	
Commercial Real Estate	3,430	3,836		3,559	3,842	
Total Commercial Loans	3,430	3,836		10,060	10,380	
With an allowance recorded:						
Commercial Loans						
Commercial	6,242	6,496	1,500	-	-	-
Total:	$31,884	$36,984	$ 2,100	$31,440	$35,430	$ 715

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The following tables summarize the average recorded investments on impaired loans specifically evaluated for impairment and the interest income recognized for the three months ended June 30, 2014 and 2013:

	For the three months ended			
	June 30, 2014		June 30, 2013	
(in thousands)	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
ORIGINATED				
Commercial Loans				
Commercial	$2,013	$ -	$3,354	$ 29
Commercial Real Estate	10,062	42	11,222	(51)
Agricultural	123	-	201	(3)
Agricultural Real Estate	1,412	12	896	12
Business Banking	548	11	78	3
Consumer Loans				
Home Equity	5,289	60	2,967	29
Residential Real Estate Mortgage	2,803	26	1,998	17
Total Originated	$22,250	$ 151	$20,716	$ 36
ACQUIRED				
Commercial Loans				
Commercial	6,315	-	-	-
Commercial Real Estate	3,462	-	-	-
Total Acquired	$9,777	$ -	$-	$ -
Total Loans	$32,027	$ 151	$20,716	$ 36

	For the six months ended			
	June 30, 2014		June 30, 2013	
(in thousands)	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
ORIGINATED				
Commercial Loans				
Commercial	$2,025	$ -	$4,331	$ 58
Commercial Real Estate	10,739	84	11,361	21
Agricultural	124	1	270	1
Agricultural Real Estate	1,418	23	898	24
Business Banking	429	23	79	3
Consumer Loans				
Home Equity	4,959	103	2,944	58
Residential Real Estate Mortgage	2,778	50	2,028	28
Total Originated	22,472	284	21,911	193
ACQUIRED				
Commercial Loans				
Commercial	6,375	-	-	-

Commercial Real Estate	3,493	-	-	-
Total Acquired	$9,868	$ -	$-	$ -
Total Loans	$32,340	$ 284	$21,911	$ 193

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Credit Quality Indicators

The Company has developed an internal loan grading system to evaluate and quantify the Company's loan portfolio with respect to quality and risk. The system focuses on, among other things, financial strength of borrowers, experience and depth of borrower's management, primary and secondary sources of repayment, payment history, nature of the business, and outlook on particular industries. The internal grading system enables the Company to monitor the quality of the entire loan portfolio on a consistent basis and provide management with an early warning system, enabling recognition and response to problem loans and potential problem loans.

Commercial Grading System

For commercial and agricultural loans, the Company uses a grading system that relies on quantifiable and measurable characteristics when available. This would include comparison of financial strength to available industry averages, comparison of transaction factors (loan terms and conditions) to loan policy, and comparison of credit history to stated repayment terms and industry averages. Some grading factors are necessarily more subjective such as economic and industry factors, regulatory environment, and management. Classified commercial loans consist of loans graded substandard and below. The grading system for commercial and agricultural loans is as follows:

· Doubtful

A doubtful loan has a high probability of total or substantial loss, but because of specific pending events that may strengthen the asset, its classification as a loss is deferred. Doubtful borrowers are usually in default, lack adequate liquidity or capital, and lack the resources necessary to remain an operating entity. Pending events can include mergers, acquisitions, liquidations, capital injections, the perfection of liens on additional collateral, the valuation of collateral, and refinancing. Generally, pending events should be resolved within a relatively short period and the ratings will be adjusted based on the new information. Nonaccrual treatment is required for doubtful assets because of the high probability of loss.

· Substandard

Substandard loans have a high probability of payment default, or they have other well-defined weaknesses. They require more intensive supervision by bank management. Substandard loans are generally characterized by current or expected unprofitable operations, inadequate debt service coverage, inadequate liquidity, or marginal capitalization. Repayment may depend on collateral or other credit risk mitigants. For some Substandard loans, the likelihood of full collection of interest and principal may be in doubt and those loans should be placed on nonaccrual. Although Substandard assets in the aggregate will have a distinct potential for loss, an individual asset's loss potential does not have to be distinct for the asset to be rated Substandard.

· Special Mention

Special Mention loans have potential weaknesses that may, if not checked or corrected, weaken the asset or inadequately protect the Company's position at some future date. These loans pose elevated risk, but their weakness does not yet justify a Substandard classification. Borrowers may be experiencing adverse operating trends (declining revenues or margins) or may be struggling with an ill-proportioned balance sheet (e.g., increasing inventory without an increase in sales, high leverage, tight liquidity). Adverse economic or market conditions, such as interest rate increases or the entry of a new competitor, may also support a Special Mention rating. Although a Special Mention loan has a higher probability of default than a pass asset, its default is not imminent.

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· Pass

Loans graded as Pass encompass all loans not graded as Doubtful, Substandard, or Special Mention. Pass loans are in compliance with loan covenants, and payments are generally made as agreed. Pass loans range from superior quality to fair quality.

Business Banking Grading System

Business banking loans are graded as either Classified or Non-classified:

· Classified

Classified loans are inadequately protected by the current worth and paying capacity of the obligor or, if applicable, the collateral pledged. These loans have a well-defined weakness, or weaknesses, that jeopardize the liquidation of the debt, or in some cases make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable. They are characterized by the distinct possibility that the Company will sustain some loss if the deficiencies are not corrected. Classified loans have a high probability of payment default, or a high probability of total or substantial loss. These loans require more intensive supervision by management and are generally characterized by current or expected unprofitable operations, inadequate debt service coverage, inadequate liquidity, or marginal capitalization. Repayment may depend on collateral or other credit risk mitigants. When the likelihood of full collection of interest and principal may be in doubt; classified loans are considered to have a nonaccrual status. In some cases, Classified loans are considered uncollectible and of such little value that their continuance as assets is not warranted.

· Non-classified

Loans graded as Non-classified encompass all loans not graded as Classified. Non-classified loans are in compliance with loan covenants, and payments are generally made as agreed.

Consumer and Residential Mortgage Grading System

Consumer and Residential Mortgage loans are graded as either Performing or Nonperforming. Nonperforming loans are loans that are 1) over 90 days past due and interest is still accruing, 2) on nonaccrual status or 3) restructured. All loans not meeting any of these three criteria are considered Performing.

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The following tables illustrate the Company's credit quality by loan class as of June 30, 2014 and December 31, 2013:

Credit Quality Indicators
As of June 30, 2014

ORIGINATED

Commercial Credit Exposure By Internally Assigned Grade:	Commercial	Commercial Real Estate	Agricultural	Agricultural Real Estate	Total
Pass	$ 606,388	$ 946,883	$ 52,603	$ 38,503	$ 1,644,377
Special Mention	11,782	19,949	354	7	32,092
Substandard	39,036	34,557	4,052	3,852	81,497
Doubtful	-	-	76	-	76
Total	$ 657,206	$ 1,001,389	$ 57,085	$ 42,362	$ 1,758,042

Business Banking Credit Exposure

By Internally Assigned Grade:	Business Banking	Total
Non-classified	$ 323,200	$ 323,200
Classified	17,514	17,514
Total	$ 340,714	$ 340,714

Consumer Credit Exposure

By Payment Activity:	Indirect	Home Equity	Direct	Total
Performing	$ 1,279,599	$ 499,588	$ 55,431	$ 1,834,618
Nonperforming	2,459	8,611	94	11,164
Total	$ 1,282,058	$ 508,199	$ 55,525	$ 1,845,782

Residential Mortgage Credit Exposure By Payment Activity:	Residential Mortgage	Total
Performing	$ 775,972	$ 775,972
Nonperforming	7,830	7,830
Total	$ 783,802	$ 783,802

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Credit Quality Indicators
As of June 30, 2014

ACQUIRED

Commercial Credit Exposure By Internally Assigned Grade:	Commercial	Commercial Real Estate	Agricultural	Total
Pass	$ 84,842	$ 197,499	$ -	$282,341
Special Mention	4,339	2,478	-	6,817
Substandard	9,507	14,238	-	23,745
Total	$ 98,688	$ 214,215	$ -	$312,903

Business Banking Credit Exposure By Internally Assigned Grade:	Business Banking	Total
Non-classified	$ 59,227	$59,227
Classified	5,360	5,360
Total	$ 64,587	$64,587

Consumer Credit Exposure By Payment Activity:	Indirect	Home Equity	Direct	Total
Performing	$ 91,807	$ 80,642	$ 6,040	$178,489
Nonperforming	172	550	42	764
Total	$ 91,979	$ 81,192	$ 6,082	$179,253

Residential Mortgage Credit Exposure By Payment Activity:	Residential Mortgage	Total
Performing	$ 285,907	$285,907
Nonperforming	3,498	3,498
Total	$ 289,405	$289,405

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Credit Quality Indicators
As of December 31, 2013

ORIGINATED

Commercial Credit Exposure By Internally Assigned Grade:	Commercial	Commercial Real Estate	Agricultural	Agricultural Real Estate	Total
Pass	$576,079	$878,411	$60,043	$33,136	$1,547,669
Special Mention	16,836	22,777	381	43	40,037
Substandard	23,508	33,128	4,726	3,473	64,835
Doubtful	-	-	12	-	12
Total	$616,423	$934,316	$65,162	$36,652	$1,652,553

Business Banking Credit Exposure By Internally Assigned Grade:	Business Banking	Total
Non-classified	$319,578	$319,578
Classified	18,101	18,101
Total	$337,679	$337,679

Consumer Credit Exposure By Payment Activity:	Indirect	Home Equity	Direct	Total
Performing	$1,158,800	$525,777	$58,151	$1,742,728
Nonperforming	3,044	7,046	132	10,222
Total	$1,161,844	$532,823	$58,283	$1,752,950

Residential Mortgage Credit Exposure By Payment Activity:	Residential Mortgage	Total
Performing	$725,308	$725,308
Nonperforming	7,913	7,913
Total	$733,221	$733,221

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Credit Quality Indicators
As of December 31, 2013

ACQUIRED

Commercial Credit Exposure By Internally Assigned Grade:	Commercial	Commercial Real Estate	Agricultural	Total
Pass	$ 85,692	$ 205,010	$ -	$290,702
Special Mention	2,230	6,183	-	8,413
Substandard	15,304	17,821	-	33,125
Total	$ 103,226	$ 229,014	$ -	$332,240

Business Banking Credit Exposure By Internally Assigned Grade:	Business Banking	Total
Non-classified	$ 65,437	$65,437
Classified	4,712	4,712
Total	$ 70,149	$70,149

Consumer Credit Exposure By Payment Activity:	Indirect	Home Equity	Direct	Total
Performing	$ 124,922	$ 86,506	$ 7,367	$218,795
Nonperforming	164	570	58	792
Total	$ 125,086	$ 87,076	$ 7,425	$219,587

Residential Mortgage Credit Exposure By Payment Activity:	Residential Mortgage	Total
Performing	$ 304,544	$304,544
Nonperforming	3,872	3,872
Total	$ 308,416	$308,416

Troubled Debt Restructured Loans

The Company's loan portfolio includes certain loans that have been modified where economic concessions have been granted to borrowers who have experienced or are expected to experience financial difficulties. These concessions typically result from the Company's loss mitigation activities and could include reductions in the interest rate, payment extensions, forgiveness of principal, forbearance or other actions. Certain TDRs are classified as nonperforming at the time of restructure and may only be returned to performing status after considering the borrower's sustained repayment performance for a reasonable period, generally six months. Substantially all of these modifications included one or a combination of the following: an extension of the maturity date at a stated rate of interest lower than the current market rate for new debt with similar risk; temporary reduction in the interest rate; or change in scheduled payment amount.

When the Company modifies a loan, management evaluates any possible impairment based on the present value of the expected future cash flows, discounted at the contractual interest rate of the original loan agreement, except when the sole (remaining) source of repayment for the loan is the operation or liquidation of the collateral. In these cases, management uses the current fair value of the collateral, less selling costs, instead of discounted cash flows. If management determines that the value of the modified loan is less than the recorded investment in the loan (net of previous charge-offs, deferred loan fees or costs and unamortized premium or discount), impairment is recognized by segment or class of loan as applicable, through an allowance estimate or a charge-off to the allowance. Segment and class status is determined by the loan's classification at origination.

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TDRs that occurred during the three month period ending June 30, 2014 consisted of 3 home equity loans totaling $0.4 million, 5 direct consumer loans totaling $0.3 million, and 2 residential real estate mortgages totaling $0.2 million. For all such modifications, the pre and post outstanding recorded investment amount remained unchanged. During the three month period ending June 30, 2014 there were 2 defaults on home equity loan TDRs totaling $0.3 million and one default on a direct consumer loan TDR totaling $34,000.

TDRs that occurred during the six month period ending June 30, 2014 consisted of 5 home equity loans totaling $0.4 million, 25 direct consumer loans totaling $1.3 million, and 15 residential real estate mortgages totaling $1.2 million. For all such modifications, the pre and post outstanding recorded investment amount remained unchanged. During the six month period ending June 30, 2014 there were 2 defaults on home equity loan TDRs totaling $0.3 million, five defaults on direct consumer loan TDRs totaling $0.2 million, and one default on a residential real estate mortgage TDR totaling $0.1 million.

TDRs that occurred during the three month period ending June 30, 2013 consisted of one commercial real estate loan totaling $0.9 million, 10 home equity loans totaling $0.5 million, and one residential real estate mortgage totaling $0.1 million. For all such modifications, the pre and post outstanding recorded investment amount remained unchanged. During the three month period ending June 30, 2013 there were three defaults on home equity loan TDRs totaling $0.2 million.

TDRs that occurred during the six month period ending June 30, 2013 consisted of one commercial real estate loan totaling $0.9 million, 14 home equity loans totaling $0.6 million, and one residential real estate mortgage totaling $0.1 million. For all such modifications, the pre and post outstanding recorded investment amount remained unchanged. During the six month period ending June 30, 2013 there were three defaults on home equity loan TDRs totaling $0.2 million.

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Note 5. Long-Term Debt

As part of a debt restructuring strategy during the second quarter of 2014, the Company repaid $165.0 million in long-term borrowings, resulting in $17.1 million in prepayment penalties. Prepayment penalties of $4.6 million were recognized as expense in the second quarter of 2014 and related to the $45.0 million of the long-term debt strategy that was completed during the quarter. The remaining prepayment penalties of approximately $13 million will be recognized in the third quarter of 2014 upon completion of the restructure strategy.

Note 6. Defined Benefit Postretirement Plans

The Company has a qualified, noncontributory, defined benefit pension plan (“the Plan”) covering substantially all of its employees at June 30, 2014. Benefits paid from the plan are based on age, years of service, compensation and social security benefits, and are determined in accordance with defined formulas. The Company’s policy is to fund the pension plan in accordance with Employee Retirement Income Security Act of 1974 (“ERISA”) standards. Assets of the plan are invested in publicly traded stocks and bonds. The Company is not required to make contributions to the Plan in 2014, and did not do so during the six months ended June 30, 2014.

The Company assumed a noncontributory, defined benefit pension plan in the Alliance Financial Corporation (“Alliance”) acquisition. This plan covers certain Alliance full-time employees who met eligibility requirements on October 6, 2006, at which time all benefits were frozen. Under the plan, retirement benefits are primarily a function of both the years of service and the level of compensation. Effective May 1, 2013, this plan was merged into the Plan.

Market conditions can result in an unusually high degree of volatility and increase the risks and short term liquidity associated with certain investments held by the Plan which could impact the value of these investments.

In addition to the Plan, the Company also provides supplemental employee retirement plans to certain current and former executives. These supplemental employee retirement plans and the Plan are collectively referred to herein as “Pension Benefits.”

Also, the Company provides certain health care benefits for retired employees. Benefits are accrued over the employees’ active service period. Only employees that were employed by the Company on or before January 1, 2000 are eligible to receive postretirement health care benefits. This health care benefits plan is contributory for participating retirees, requiring participants to absorb certain deductibles and coinsurance amounts with contributions adjusted annually to reflect cost sharing provisions and benefit limitations called for in the plan. Eligibility is contingent upon the direct transition from active employment status to retirement without any break in employment from the Company. Employees also must be participants in the Company’s medical plan prior to their retirement. The Company funds the cost of postretirement health care as benefits are paid. The Company elected to recognize the transition obligation on a delayed basis over twenty years. In addition, the Company assumed post-retirement medical life insurance benefits for certain Alliance employees, retirees and their spouses, if applicable, in the Alliance acquisition. These postretirement benefits are referred to herein as “Other Benefits.” The components of expense for Pension Benefits and Other Benefits are set forth below (in thousands):

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	Pension Benefits		Other Benefits	
	Three months ended June 30,		Three months ended June 30,	
Components of net periodic benefit cost:	2014	2013	2014	2013
Service cost	$587	$604	$4	$6
Interest cost	1,040	830	90	75
Expected return on plan assets	(2,175)	(1,929)	-	-
Net amortization	25	711	(6)	(1)
Total cost (benefit)	$(523)	$216	$88	$80

	Pension Benefits		Other Benefits	
	Six months ended June 30,		Six months ended June 30,	
Components of net periodic benefit cost:	2014	2013	2014	2013
Service cost	$1,174	$1,209	$8	$12
Interest cost	2,080	1,659	180	150
Expected return on plan assets	(4,350)	(3,858)	-	-
Net amortization	50	1,314	(12)	222
Total cost (benefit)	$(1,046)	$324	$176	$384

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Note 7. Earnings Per Share

Basic earnings per share excludes dilution and is computed by dividing income available to common stockholders by the weighted average number of common shares outstanding for the period. Diluted earnings per share reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock that then shared in the earnings of the entity (such as the Company’s dilutive stock options and restricted stock units).

The following is a reconciliation of basic and diluted earnings per share for the periods presented in the consolidated statements of income.

Three months ended June 30,	2014	2013
(in thousands, except per share data)		
Basic EPS:		
Weighted average common shares outstanding	43,865	43,923
Net income available to common shareholders	27,640	16,916
Basic EPS	$0.63	$0.39
Diluted EPS:		
Weighted average common shares outstanding	43,865	43,923
Dilutive effect of common stock options and restricted stock	498	393
Weighted average common shares and common share equivalents	44,363	44,316
Net income available to common shareholders	27,640	16,916
Diluted EPS	$0.62	$0.38

Six months ended June 30,	2014	2013
(in thousands, except per share data)		
Basic EPS:		
Weighted average common shares outstanding	43,829	40,187
Net income available to common shareholders	45,649	24,565
Basic EPS	$1.04	$0.61
Diluted EPS:		
Weighted average common shares outstanding	43,829	40,187
Dilutive effect of common stock options and restricted stock	500	388
Weighted average common shares and common share equivalents	44,329	40,575
Net income available to common shareholders	45,649	24,565
Diluted EPS	$1.03	$0.61

There were 503,058 stock options for the quarter ended June 30, 2014 and 1,231,395 stock options for the quarter ended June 30, 2013 that were not considered in the calculation of diluted earnings per share since the stock options’ exercise price was greater than the average market price during these periods.

There were 500,541 stock options for the six months ended June 30, 2014 and 1,203,046 stock options for the six months ended June 30, 2013 that were not considered in the calculation of diluted earnings per share since the stock options’ exercise price was greater than the average market price during these periods.

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Note 8. Reclassification Adjustments Out of Other Comprehensive Income (Loss)

The following table summarizes the reclassification adjustments out of accumulated other comprehensive income (loss) (in thousands):

Detail About Accumulated Other Comprehensive Income (Loss) Components	Amount reclassified from accumulated other comprehensive income (loss) Three months ended June 30, 2014	June 30, 2013	Affected line item in the consolidated statement of comprehensive income (loss)
Available for sale securities:			
(Gains) losses on available for sale securities	$ (14)	$ 61	Net securities (gains) losses
Tax expense (benefit)	6	(24)	Income tax expense
Net of tax	$ (8)	$ 37	
Pension and other benefits:			
Amortization of net gains	$ 74	$ 765	Salaries and employee benefits
Amortization of prior service costs	(55)	(55)	Salaries and employee benefits
Tax benefit	8	284	Income tax expense
Net of tax	$ 11	$ 426	
Total reclassifications during the period, net of tax	$ 3	$ 463	

Detail About Accumulated Other Comprehensive Income (Loss) Components	Amount reclassified from accumulated other comprehensive income (loss) Six months ended June 30, 2014	June 30, 2013	Affected line item in the consolidated statement of comprehensive income (loss)
Available for sale securities:			
Gains on available for sale securities	$ (21)	$ (1,084)	Net securities gains
Tax expense	8	434	Income tax expense
Net of tax	$ (13)	$ (650)	
Pension and other benefits:			
Amortization of net gains	$ 148	$ 1,647	Salaries and employee benefits
Amortization of prior service costs	(110)	(111)	Salaries and employee benefits

Tax benefit	15	614	Income tax expense
Net of tax	$23	$922	
Total reclassifications during the period, net of tax	$10	$272	

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Note 9. Fair Value Measurements and Fair Value of Financial Instruments

U.S. GAAP states that fair value is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. Fair value measurements are not adjusted for transaction costs. A fair value hierarchy exists within U.S. GAAP that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (level 1 measurements) and the lowest priority to unobservable inputs (level 3 measurements). The three levels of the fair value hierarchy are described below:

Level 1 - Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities;

Level 2 - Quoted prices for similar assets or liabilities in active markets, quoted prices in markets that are not active, or inputs that are observable, either directly or indirectly, for substantially the full term of the asset or liability;

Level 3 - Prices or valuation techniques that require inputs that are both significant to the fair value measurement and unobservable (i.e., supported by little or no market activity).

A financial instrument's level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement.

The types of instruments valued based on quoted market prices in active markets include most U.S. government and agency securities, many other sovereign government obligations, liquid mortgage products, active listed equities and most money market securities. Such instruments are generally classified within level 1 or level 2 of the fair value hierarchy. The Company does not adjust the quoted price for such instruments.

The types of instruments valued based on quoted prices in markets that are not active, broker or dealer quotations, or alternative pricing sources with reasonable levels of price transparency include most investment-grade and high-yield corporate bonds, less liquid mortgage products, less liquid agency securities, less liquid listed equities, state, municipal and provincial obligations, and certain physical commodities. Such instruments are generally classified within level 2 of the fair value hierarchy.

Level 3 is for positions that are not traded in active markets or are subject to transfer restrictions, valuations are adjusted to reflect illiquidity and/or non-transferability, and such adjustments are generally based on available market evidence. In the absence of such evidence, management's best estimate will be used. Management's best estimate consists of both internal and external support on certain Level 3 investments. Subsequent to inception, management only changes level 3 inputs and assumptions when corroborated by evidence such as transactions in similar instruments, completed or pending third-party transactions in the underlying investment or comparable entities, subsequent rounds of financing, recapitalizations and other transactions across the capital structure, offerings in the equity or debt markets, and changes in financial ratios or cash flows.

For the six month period ending June 30, 2014, the Company has made no transfers of assets between Level 1 and Level 2, and has had no Level 3 activity.

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The following tables set forth the Company’s financial assets and liabilities measured on a recurring basis that were accounted for at fair value. Assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement (in thousands):

June 30, 2014:

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Balance as of June 30, 2014
Assets:				
Securities Available for Sale:				
U.S. Treasury	$33,324	$-	$ -	$33,324
Federal Agency	-	307,141	-	307,141
State & municipal	-	105,348	-	105,348
Mortgage-backed	-	397,387	-	397,387
Collateralized mortgage obligations	-	519,809	-	519,809
Other securities	7,511	8,279	-	15,790
Total Securities Available for Sale	$40,835	$1,337,964	$ -	$1,378,799
Trading Securities	7,355	-	-	7,355
Interest Rate Swaps	-	2,799	-	2,799
Total	$48,190	$1,340,763	$ -	$1,388,953
Liabilities:				
Interest Rate Swaps	$-	$2,799	$ -	$2,799
Total	$-	$2,799		