CITY HOLDING CO
Form 10-Q
November 07, 2013

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)
[X] QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For The Quarterly Period Ended September 30, 2013
OR
[ ] TRANSITION REPORT PURSANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For The Transition Period From ____________To_____________.

Commission File number 0-11733
CITY HOLDING COMPANY
(Exact name of registrant as specified in its charter)

West Virginia	55-0619957
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

25 Gatewater Road	
Charleston, West Virginia	25313
(Address of principal executive offices)	(Zip Code)

(304) 769-1100
(Registrant’s telephone number, including area code)

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

Indicate by check mark whether the registrant 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 [X] No [ ]

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

Large accelerated filer [ ]	Accelerated filer [X]
Non-accelerated filer [ ]	Smaller reporting company [ ]

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practical date.
Common stock, $2.50 Par Value – 15,730,090 shares as of November 1, 2013.

1

FORWARD-LOOKING STATEMENTS

All statements other than statements of historical fact included in this Quarterly Report on Form 10-Q, including statements in Management’s Discussion and Analysis of Financial Condition and Result of Operations are, or may be deemed to be, forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. Such information involves risks and uncertainties that could result in the Company’s actual results differing from those projected in the forward-looking statements. Important factors that could cause actual results to differ materially from those discussed in such forward-looking statements include, but are not limited to: (1) the Company may incur additional loan loss provision due to negative credit quality trends in the future that may lead to a deterioration of asset quality; (2) the Company may incur increased charge-offs in the future; (3) the Company could have adverse legal actions of a material nature; (4) the Company may face competitive loss of customers; (5) the Company may be unable to manage its expense levels; (6) the Company may have difficulty retaining key employees; (7) changes in the interest rate environment may have results on the Company’s operations materially different from those anticipated by the Company’s market risk management functions; (8) changes in general economic conditions and increased competition could adversely affect the Company’s operating results; (9) changes in other regulations and government policies affecting bank holding companies and their subsidiaries, including changes in monetary policies, could negatively impact the Company’s operating results; (10) the Company may experience difficulties growing loan and deposit balances; (11) the current economic environment poses significant challenges for us and could adversely affect the Company's financial condition and results of operations; (12) continued deterioration in the financial condition of the U.S. banking system may impact the valuations of investments the Company has made in securities of other financial institutions resulting in either actual losses or other than temporary impairments on such investments; (13) the effects of the Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") adopted by the United States Congress; and (14) the integration of the operations of City Holding and Community Financial may be more difficult than anticipated. Forward-looking statements made herein reflect management’s expectations as of the date such statements are made. Such information is provided to assist stockholders and potential investors in understanding current and anticipated financial operations of the Company and is included pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. The Company undertakes no obligation to update any forward-looking statement to reflect events or circumstances that arise after the date such statements are made.

Table of Contents

Index
City Holding Company and Subsidiaries

Table of Contents

Part I - Financial Information

Item 1 - Financial Statements

Consolidated Balance Sheets
City Holding Company and Subsidiaries
(in thousands)

Assets	September 30, 2013 (Unaudited)	December 31, 2012
Cash and due from banks	$164,915	$58,718
Interest-bearing deposits in depository institutions	14,706	16,276
Federal funds sold	—	10,000
Cash and Cash Equivalents	179,621	84,994
Investment securities available for sale, at fair value	329,247	377,122
Investment securities held-to-maturity, at amortized cost (approximate fair value at September 30, 2013 and December 31, 2012, - $6,406 and $13,861, respectively)	3,994	13,454
Other securities	13,344	11,463
Total Investment Securities	346,585	402,039
Gross loans	2,558,456	2,146,369
Allowance for loan losses	(20,606)	(18,809)
Net Loans	2,537,850	2,127,560
Bank owned life insurance	91,249	81,901
Premises and equipment, net	82,194	72,728
Accrued interest receivable	8,108	6,692
Net deferred tax asset	45,183	32,737
Goodwill and other intangible assets	76,420	65,057
Other assets	29,478	43,758
Total Assets	$3,396,688	$2,917,466
Liabilities		
Deposits:		
Noninterest-bearing	$498,245	$429,969
Interest-bearing:		
Demand deposits	604,047	553,132
Savings deposits	606,514	506,869
Time deposits	1,098,730	919,346
Total Deposits	2,807,536	2,409,316
Short-term borrowings:		
Customer repurchase agreements	150,943	114,646
Long-term debt	16,495	16,495
Other liabilities	43,672	43,735
Total Liabilities	3,018,646	2,584,192
Shareholders’ Equity		

Preferred stock, par value $25 per share: 500,000 shares authorized; none issued	—	—

4

Table of Contents

Common stock, par value $2.50 per share: 50,000,000 shares authorized; 18,499,282 shares issued at September 30, 2013 and December 31, 2012, less 2,769,192 and 3,665,999 shares in treasury, respectively	46,249	46,249
Capital surplus	107,275	103,524
Retained earnings	326,553	309,270
Cost of common stock in treasury	(95,861)	(124,347)
Accumulated other comprehensive income (loss):		
Unrealized (loss) gain on securities available-for-sale	(1,179)	3,573
Underfunded pension liability	(4,995)	(4,995)
Total Accumulated Other Comprehensive Loss	(6,174)	(1,422)
Total Shareholders’ Equity	378,042	333,274
Total Liabilities and Shareholders’ Equity	$3,396,688	$2,917,466

See notes to consolidated financial statements.

Table of Contents

Consolidated Statements of Income (Unaudited)
City Holding Company and Subsidiaries
(in thousands, except earnings per share data)

Interest Income	Three months ended September 30, 2013	2012	Nine months ended September 30, 2013	2012
Interest and fees on loans	$32,983	$24,633	$94,693	$70,843
Interest on investment securities:				
Taxable	2,392	3,438	7,774	11,345
Tax-exempt	299	346	935	1,101
Interest on federal funds sold	—	15	22	38
Total Interest Income	35,674	28,432	103,424	83,327
Interest Expense				
Interest on deposits	3,068	3,312	9,490	10,363
Interest on short-term borrowings	82	79	232	229
Interest on long-term debt	154	166	464	499
Total Interest Expense	3,304	3,557	10,186	11,091
Net Interest Income	32,370	24,875	93,238	72,236
Provision for loan losses	1,154	975	4,903	4,600
Net Interest Income After Provision for Loan Losses	31,216	23,900	88,335	67,636
Non-interest Income				
Total investment securities impairment losses	—	(272)	—	(878)
Noncredit impairment losses recognized in other comprehensive income	—	—	—	302
Net investment securities impairment losses	—	(272)	—	(576)
Gains on sale of investment securities	—	730	93	1,530
Net investment securities gains	—	458	93	954
Service charges	7,169	6,751	20,601	19,296
Bankcard revenue	3,468	3,110	10,117	9,305
Insurance commissions	1,365	1,439	4,563	4,782
Trust and investment management fee income	939	912	2,893	2,662
Bank owned life insurance	805	738	2,416	2,228
Other income	734	671	2,376	1,762
Total Non-interest Income	14,480	14,079	43,059	40,989
Non-interest Expense				
Salaries and employee benefits	12,930	11,295	38,519	32,207
Occupancy and equipment	2,409	2,126	7,381	6,038
Depreciation	1,437	1,175	4,289	3,371
FDIC insurance expense	500	405	1,352	1,184
Advertising	712	674	2,266	1,993
Bankcard expenses	680	720	2,173	2,035
Postage, delivery, and statement mailings	541	529	1,698	1,565
Office supplies	416	407	1,320	1,258
Legal and professional fees	591	611	1,561	1,349

Telecommunications	721	433	1,631	1,209
Repossessed asset losses, net of expenses	896	429	718	1,200

6

Table of Contents

Merger related costs	(150)	157	5,455	4,335
Other expenses	2,982	2,885	9,664	8,382
Total Non-interest Expense	24,665	21,846	78,027	66,126
Income Before Income Taxes	21,031	16,133	53,367	42,499
Income tax expense	7,056	5,526	18,398	14,450
Net Income Available to Common Shareholders	$13,975	$10,607	$34,969	$28,049
Total comprehensive income	$13,342	$12,719	$30,217	$31,591
Average common shares outstanding	15,608	14,751	15,545	14,700
Effect of dilutive securities:				
Employee stock awards and warrants outstanding	182	83	168	83
Shares for diluted earnings per share	15,790	14,834	15,713	14,783
Basic earnings per common share	$0.89	$0.71	$2.23	$1.89
Diluted earnings per common share	$0.88	$0.71	$2.21	$1.88
Dividends declared per common share	$0.37	$0.35	$1.11	$1.05

See notes to consolidated financial statements.

Table of Contents

Consolidated Statements of Comprehensive Income (Unaudited)
City Holding Company and Subsidiaries
(in thousands)

	Three Months Ended September 30, 2013	Three Months Ended September 30, 2012	Nine Months Ended September 30, 2013	Nine Months Ended September 30, 2012
Net income	$13,975	$10,607	$34,969	$28,049
Unrealized gains (losses) on available-for-sale securities arising during the period	(1,004)	3,847	(7,438)	6,637
Reclassification adjustment for (gains)	—	(458)	(93)	(954)
Other comprehensive income (loss) before income taxes	(1,004)	3,389	(7,531)	5,683
Tax effect	371	(1,277)	2,779	(2,141)
Other comprehensive income (loss), net of tax	(633)	2,112	(4,752)	3,542
Comprehensive income, net of tax	$13,342	$12,719	$30,217	$31,591

See notes to consolidated financial statements.

Consolidated Statements of Changes in Shareholders' Equity (Unaudited)
City Holding Company and Subsidiaries
Nine Months Ended September 30, 2013 and 2012
(in thousands)

	Common Stock	Capital Surplus	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Income (Loss)	Total Shareholders' Equity
Balance at December 31, 2011	$46,249	$103,335	$291,050	$(125,593)	(3,907)	$311,134
Net income			28,049			28,049
Other comprehensive income					3,542	3,542
Acquisition of Virginia Savings Bancorp, Inc.		276		7,447		7,723
Cash dividends declared ($1.05 per share)			(15,532)			(15,532)
Stock-based compensation expense, net		(179)		1,049		870
Exercise of 18,899 stock options		(121)		665		544
Purchase of 237,535 treasury shares				(7,915)		(7,915)
Balance at September 30, 2012	$46,249	$103,311	$303,567	$(124,347)	$ (365)	$328,415

Table of Contents

	Common Stock	Capital Surplus	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Income (Loss)	Total Shareholders' Equity
Balance at December 31, 2012	46,249	$103,524	$309,270	(124,347)	$ (1,422)	$333,274
Net income			34,969			34,969
Other comprehensive loss					(4,752)	(4,752)
Acquisition of Community Financial Corporation		4,236		24,272		28,508
Cash dividends declared ($1.11 per share)			(17,686)			(17,686)
Stock-based compensation expense, net		(315)		1,278		963
Exercise of 107,140 stock options		(170)		2,936		2,766
Balance at September 30, 2013	46,249	$107,275	$326,553	(95,861)	$ (6,174)	$378,042

See notes to consolidated financial statements.

Table of Contents

Consolidated Statements of Cash Flows (Unaudited)
City Holding Company and Subsidiaries
(in thousands)

	Nine months ended September 30,	
	2013	2012
Net income	$34,969	$28,049
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization and accretion	(7,885)	1,356
Provision for loan losses	4,903	4,600
Depreciation of premises and equipment	4,289	3,371
Deferred income tax expense	4,945	342
Net periodic employee benefit cost	586	391
Realized investment securities gains	(93)	(1,530)
Net investment securities impairment losses	—	576
Stock-compensation expense	963	870
Increase in value of bank-owned life insurance	(2,413)	(2,164)
Loans originated for sale	(20,895)	(30,518)
Proceeds from the sale of loans originated for sale	25,816	29,358
Gain on sale of loans	(553)	(626)
Change in accrued interest receivable	(22)	(137)
Change in other assets	20,734	(735)
Change in other liabilities	(6,922)	2,092
Net Cash Provided by Operating Activities	58,422	35,295
Proceeds from sales of securities available-for-sale	18,398	27,773
Proceeds from maturities and calls of securities available-for-sale	78,671	113,760
Proceeds from maturities and calls of securities held-to-maturity	9,504	10,046
Purchases of securities available-for-sale	(42,295)	(150,497)
Net (increase) in loans	(39,643)	(41,870)
Purchases of premises and equipment	(4,663)	(5,910)
Acquisition of Community Financial Corporation, net of cash acquired of $8,888	(21,852)	—
Acquisition of Virginia Savings Bancorp, net of cash acquired of $24,943	—	20,275
Net Cash Used in Investing Activities	(1,880)	(26,423)
Net increase in noninterest-bearing deposits	25,440	26,777
Net (decrease) increase in interest-bearing deposits	(9,360)	10,815
Net increase (decrease) in short-term borrowings	36,297	(57,103)
Purchases of treasury stock	—	(7,915)
Proceeds from exercise of stock options	2,766	544
Dividends paid	(17,058)	(15,517)
Net Cash Provided by (Used in) Financing Activities	38,085	(42,399)
Increase (decrease) in Cash and Cash Equivalents	94,627	(33,527)
Cash and cash equivalents at beginning of period	84,994	146,399
Cash and Cash Equivalents at End of Period	$179,621	$112,872

See notes to consolidated financial statements.

Table of Contents

Notes to Consolidated Financial Statements (Unaudited)
September 30, 2013

Note A –Basis of Presentation

The accompanying consolidated financial statements, which are unaudited, include all of the accounts of City Holding Company (“the Parent Company”) and its wholly-owned subsidiaries (collectively, “the Company”). All material intercompany transactions have been eliminated. The consolidated financial statements include all adjustments that, in the opinion of management, are necessary for a fair presentation of the results of operations and financial condition for each of the periods presented. Such adjustments are of a normal recurring nature. The results of operations for nine months ended September 30, 2013 are not necessarily indicative of the results of operations that can be expected for the year ending December 31, 2013. The Company’s accounting and reporting policies conform with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Such policies require management to make estimates and develop assumptions that affect the amounts reported in the consolidated financial statements and related footnotes. Actual results could differ from management’s estimates.

The consolidated balance sheet as of December 31, 2012 has been derived from audited financial statements included in the Company’s 2012 Annual Report to Shareholders. Certain information and footnote disclosures normally included in annual financial statements prepared in accordance with U.S. generally accepted accounting principles have been omitted. These financial statements should be read in conjunction with the financial statements and notes thereto included in the 2012 Annual Report of the Company.

Certain amounts in the financial statements have been reclassified. Such reclassifications had no impact on shareholders’ equity or net income for any period.

Note B - Recent Accounting Pronouncements

In January 2013, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2013-01, "Balance Sheet (Topic 210) - Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities." This ASU requires an entity to disclose both the gross and net information about financial instruments, such as derivatives, that are eligible for offset in the balance sheet. ASU No. 2013-01 became effective for the Company on January 1, 2013. The adoption of ASU No. 2013-01 did not have a material impact on the Company's financial statements. See Note I - Derivative Instruments for applicable disclosures.

In February 2013, the FASB issued ASU No. 2013-02, "Comprehensive Income (Topic 220) - Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income." This ASU requires entities to provide information about the amounts reclassified out of accumulated other comprehensive income by component. In addition, an entity is required to present, either on the face of the statement where net income is presented or in the notes, significant amounts reclassified out of accumulated other comprehensive income by the respective line items of net income but only if the amounts reclassified is required under U.S. GAAP to be reclassified to net income in its entirety in the same reporting period. For other amounts that are not required under U.S. GAAP to be reclassified in their entirety to net income, an entity is required to cross-reference to other disclosures required under U.S. GAAP that provide additional detail about those amounts. ASU No. 2013-02 became effective for the Company beginning on January 1, 2013. The adoption of ASU No. 2013-02 did not have a material impact on the Company's financial statements.

In July 2013, the FASB issued ASU No. 2013-10, "Derivatives and Hedging (Topic 815) - Inclusion of the Fed Funds Effective Swap Rate (or Overnight Index Swap Rate) as a Benchmark Interest Rate for Hedge Accounting Purposes." This ASU permits the Fed Funds Effective Swap Rate (or Overnight Index Swap Rate) to be used as a U.S.

benchmark interest rate for hedge accounting purposes under Topic 815, in addition to interest rates on direct Treasury obligations of the U.S. government and the London Interbank Offered Rate ("LIBOR"). ASU 2013 is effective prospectively for qualifying new or redesignated hedging relationships entered into on or after July 17, 2013 and did not have a material impact on the Company's financial statements.

In July 2013, the FASB issued ASU No. 2013-11, "Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists." This ASU requires entities to present an unrecognized tax benefit, or a portion of an unrecognized tax benefit, as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward, subject to certain exceptions. This ASU will become effective for the Company beginning on January 1, 2014. The adoption of ASU No. 2013-11 is not expected to have a material impact on the Company's financial statements.

Table of Contents

Note C –Acquisitions

On May 31, 2012, the Company acquired 100% of the outstanding common and preferred stock of Virginia Savings Bancorp, Inc. and its wholly owned subsidiary, Virginia Savings Bank (collectively, “Virginia Savings”). As a result of this acquisition, the Company acquired five branches which expanded its footprint into Virginia. At the time of closing, Virginia Savings had total assets of $132 million, loans of $82 million, deposits of $120 million and shareholders’ equity of $11 million.
The total transaction was valued at $12.4 million, consisting of cash of $4.7 million and approximately 240,000 shares of common stock valued at $7.7 million. The common stock was valued based on the closing price of $32.18 for the Company’s common shares on May 31, 2012.

On January 10, 2013, the Company acquired 100% of the outstanding common and preferred stock of Community Financial Corporation and its wholly owned subsidiary, Community Bank (collectively, "Community"). As a result of this acquisition, the Company acquired eight branches along the I-81 corridor in western Virginia and two branches in Virginia Beach, Virginia. At the time of closing, Community had total assets of $460 million, loans of $410 million, deposits of $380 million and shareholders' equity of $53 million. Community shareholders received 0.1753 shares of the Company's common stock for each share of Community Financial Corporation stock, resulting in the issuance of approximately 767,000 shares of the Company's common stock valued at $27.8 million. The common stock was valued based on the closing price of $36.23 for the Company's common stock on January 9, 2013. In conjunction with this acquisition, the Company repurchased $12.7 million of Community preferred stock previously issued to the U.S. Department of Treasury ("Treasury Department"). A related warrant issued by Community to the Treasury Department has been converted into a warrant to purchase 61,565 shares of the Company's common stock, with an exercise price of $30.80 per share and an expiration period of ten years, which was subsequently reduced to six years. Based on the preliminary purchase price allocation, the Company recorded an estimate of goodwill of $9.3 million and a core deposit intangible of $2.7 million as a result of this acquisition. The Company has recorded estimates of the fair values of the acquired assets and liabilities. These fair value estimates are provisional amounts based on third-party valuations that are currently under review.

Table of Contents

The purchase price of both acquisitions has been allocated as follows (in thousands):

	Virginia Savings	(preliminary) Community	Total
Date of acquisition	May 31, 2012	January 10, 2013	
Consideration:			
Cash	$4,672	$12,738	$17,410
Common stock	7,723	27,783	35,506
Warrant issued	—	725	725
	$12,395	$41,246	$53,641
Identifiable assets:			
Cash and cash equivalents	$24,943	$8,888	$33,831
Investment securities	14,082	17,659	31,741
Loans	73,463	370,754	444,217
Bank owned life insurance	—	6,935	6,935
Premises and equipment	5,158	8,950	14,108
Deferred tax asset, net	4,173	15,228	19,401
Other assets	4,626	7,988	12,614
Total identifiable assets	126,445	436,402	562,847
Identifiable liabilities:			
Deposits	122,723	383,070	505,793
Other liabilities	841	24,086	24,927
Total identifiable liabilities	123,564	407,156	530,720
Net identifiable asset	2,881	29,246	32,127
Goodwill	8,241	9,289	17,530
Core deposit intangible	1,273	2,711	3,984
	$12,395	$41,246	$53,641

Acquired Loans

In determining the estimated fair value of the acquired loans, management considered several factors, such as estimated future credit losses, estimated prepayments, remaining lives of the acquired loans, estimated value of the underlying collateral and the net present value of the cash flows expected to be received. For smaller loans not specifically reviewed, management grouped the loans into their respective homogeneous loan pool and applied a fair value estimate accordingly.

Acquired loans are accounted for using one of the two following accounting standards:

(1) ASC Topic 310-20 is used to value loans that do not have evidence of credit quality deterioration. For these loans, the difference between the fair value of the loan and the amortized cost of the loan would be amortized or accreted into income using the interest method.

(2) ASC Topic 310-30 is used to value loans that have evidence of credit quality deterioration. For these loans, the expected cash flows that exceed the fair value of the loan represent the accretable yield, which is recognized as interest income on a level-yield basis over the expected cash flow periods of the loans. The non-accretable difference represents the difference between the contractually required principal and interest payments and the cash flows expected to be collected based upon management's estimation. Subsequent decreases in the expected cash flows will require the Company to evaluate the need for additions to the Company's allowance for loan

losses. Subsequent increases in the expected cash flows will result in a reversal of the provision for loan losses to the extent of prior charges with a corresponding adjustment to the accretable yield, which will result in the recognition of additional interest income over the remaining lives of the loans.

Table of Contents

The following table presents the purchased credit-impaired loans acquired in conjunction with both acquisitions (in thousands):

	Virginia Savings	Community	Total
Contractually required principal and interest	$11,567	$58,014	$69,581
Contractual cash flows not expected to be collected (non-accretable difference)	(3,973)	(20,724)	(24,697)
Expected cash flows	7,594	37,290	44,884
Interest component of expected cash flows (accretable difference)	(954)	(5,587)	(6,541)
Estimated fair value of purchased credit impaired loans acquired	$6,640	$31,703	$38,343

Acquired Deposits

The fair values of non-time deposits approximated their carrying value at the acquisition date. For time deposits, the fair values were estimated based on discounted cash flows, using interest rates that are currently being offered compared to the contractual interest rates. Based on these analyses, management recorded a premium on time deposits acquired of $2.3 million and $1.1 million, for the Virginia Savings and Community acquisitions, respectively, each of which is being amortized over five years.

Core Deposit Intangible

The Company believes that the customer relationships with the deposits acquired have an intangible value. In connection with the acquisition, the Company recorded a core deposit intangible asset of $1.3 million and $2.7 million, for Virginia Savings and Community, respectively. Each of the core deposit intangible assets represent the value that the acquiree had with their deposit customers. The fair value was estimated based on a discounted cash flow methodology that considered type of deposit, deposit retention and the cost of the deposit base. The core deposit intangible is being amortized over ten years, with an annual charge of less than $0.7 million per year. The following table presents a rollforward of the Company's intangible assets from the beginning of the year (in thousands):

	Intangible Assets
Balance, beginning of period	$2,069
Core deposit intangible acquired in conjunction with the acquisition of Community	2,711
Amortization expense	(779)
Balance, end of period	$4,001

Goodwill

Under GAAP, management has up to twelve months following the date of the acquisition to finalize the fair values of acquired assets and liabilities. The measurement period ends as soon as the Company receives information it was seeking about facts and circumstances that existed as of the acquisition date or learns more information is not obtainable. Any subsequent adjustments to the fair value of the acquired assets and liabilities, intangible assets or other purchase accounting adjustments during the measurement period will result in adjustments to the goodwill recorded. The measurement period is limited to one year from the acquisition date. The goodwill recorded in conjunction with the Virginia Savings and Community acquisitions is not expected to be deductible for tax purposes. The following table presents a rollforward of goodwill from the beginning of the year (in thousands):

	Goodwill
Balance, beginning of period	$62,988

Adjustment to goodwill acquired in conjunction with the acquisition of Virginia Savings	142
Goodwill acquired in conjunction with the acquisition of Community	9,289
Balance, end of period	$72,419

Table of Contents

Merger Related Costs

During the three and nine months ended September 30, 2013, the Company incurred less than $0.1 million and $5.5 million of merger-related costs in connection with the Community acquisition. These costs were primarily for severance ($2.5 million), professional fees ($1.4 million) and data processing costs ($1.1 million).

During the three and nine months ended September 30, 2012, the Company incurred $0.2 million and $4.3 million of merger-related costs in the connection with the Virginia Savings acquisition. These costs were primarily for severance ($0.9 million), professional fees ($0.9 million) and data processing costs ($2.3 million).

Note D –Investments

The amortized cost and estimated fair values of the Company's securities are shown in the following table (in thousands):

	September 30, 2013				December 31, 2012			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Securities available-for-sale:								
U.S. Treasuries and U.S. government agencies	$2,511	$61	$—	$2,572	$3,792	$96	$—	$3,888
Obligations of states and political subdivisions	41,109	814	74	41,849	47,293	1,651	15	48,929
Mortgage-backed securities:								
U.S. government agencies	255,889	3,351	4,601	254,639	279,336	7,231	85	286,482
Private label	2,383	19	2	2,400	3,235	37	—	3,272
Trust preferred securities	13,456	1,047	2,495	12,008	15,402	55	2,812	12,645
Corporate securities	9,783	172	639	9,316	16,152	207	412	15,947
Total Debt Securities	325,131	5,464	7,811	322,784	365,210	9,277	3,324	371,163
Marketable equity securities	3,381	1,575	—	4,956	3,381	804	—	4,185
Investment funds	1,525	—	18	1,507	1,724	50	—	1,774
Total Securities Available-for-Sale	$330,037	$7,039	$7,829	$329,247	$370,315	$10,131	$3,324	$377,122

	September 30, 2013				December 31, 2012			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Securities held-to-maturity								
Trust preferred securities	$3,994	$2,412	$—	$6,406	$13,454	$465	$58	$13,861

Total Securities Held-to-Maturity	$3,994	$2,412	$—	$6,406	$13,454	$465	$58	$13,861
Other investment securities:								
Non-marketable equity securities	$13,344	$—	$—	$13,344	$11,463	$—	$—	$11,463
Total Other Investment Securities	$13,344	$—	$—	$13,344	$11,463	$—	$—	$11,463

Securities with limited marketability, such as stock in the Federal Reserve Bank or the Federal Home Loan Bank, are carried at cost and are reported as non-marketable equity securities in the table above.

Certain investment securities owned by the Company were in an unrealized loss position (i.e., amortized cost basis exceeded the estimated fair value of the securities). The following table shows the gross unrealized losses and fair value of the Company's investments aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position (in thousands):

Table of Contents

	September 30, 2013					
	Less Than Twelve Months		Twelve Months or Greater		Total	
	Estimated Fair Value	Unrealized Loss	Estimated Fair Value	Unrealized Loss	Estimated Fair Value	Unrealized Loss
Securities available-for-sale:						
Obligations of states and political subdivisions	$3,471	$73	$448	$1	$3,919	$74
Mortgage-backed securities:						
U.S. Government agencies	129,114	4,485	5,217	116	134,331	4,601
Private label	1,604	2	—	—	1,604	2
Trust preferred securities	130	270	4,497	2,225	4,627	2,495
Corporate securities	6,081	639	—	—	6,081	639
Investment funds	1,482	18	—	—	1,482	18
Total	$141,882	$5,487	$10,162	$2,342	$152,044	$7,829

	December 31, 2012					
	Less Than Twelve Months		Twelve Months or Greater		Total	
	Estimated Fair Value	Unrealized Loss	Estimated Fair Value	Unrealized Loss	Estimated Fair Value	Unrealized Loss
Securities available-for-sale:						
Obligations of states and political subdivisions	$1,163	$15	$—	$—	$1,163	$15
Mortgage-backed securities:						
U.S. Government agencies	16,225	85	—	—	16,225	85
Trust preferred securities	348	51	5,836	2,761	6,184	2,812
Corporate securities	1,950	49	4,344	363	6,294	412
Total	$19,686	$200	$10,180	$3,124	$29,866	$3,324
Securities held-to-maturity:						
Trust preferred securities	$—	$—	$3,380	$58	$3,380	$58

Marketable equity securities consist of investments made by the Company in equity positions of various community banks. Included within this portfolio are meaningful (2-5%) ownership positions in the following community bank holding companies: First National Corporation (FXNC) and First United Corporation (FUNC).

During the nine months ended September 30, 2013, the Company did not record any credit-related net investment impairment losses. During the nine months ended September 30, 2012, the Company recorded $0.6 million in credit-related net investment impairment losses. The charges deemed to be other-than-temporary were related to pooled bank trust preferred securities with a remaining carrying value of $5.6 million at September 30, 2012. The credit-related net impairment charges related to the pooled bank trust preferred securities were based on the Company's quarterly reviews of its investment securities for indications of losses considered to be other-than-temporary. 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 would be reflected in earnings as realized losses. 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, capital strength, and near-term (12 months) prospects of the issuer, including any specific events which may influence the operations of the issuer such as changes in technology that may impair the earnings potential of the investment or the discontinuance of a segment of the business that may affect the future earnings potential; (iii) the historical volatility in the market value of the investment and/or the liquidity or illiquidity of the investment; (iv) adverse conditions specifically related to the security, an industry, or a geographic area; or (v) the intent to sell the investment security and if it's more likely than not that the Company will not have to sell the security before recovery of its cost basis. In addition, management also employs a continuous monitoring process in regards to its marketable equity securities, specifically its portfolio of regional community bank holdings. Although the regional community bank stocks that are owned by the Company are publicly traded, the trading activity for these stocks is minimal, with trading volumes of less than 0.1% of each respective company being traded on a daily basis. Another factor influencing the market value of these equity securities is a depressed stock market, particularly in the smaller community bank financial sector. As part of management's review process for these securities, management reviews the financial condition of each respective regional community bank for any indications of financial weakness.

Table of Contents

Management has the ability and intent to hold the securities classified as held to maturity until they mature, at which time the Company will receive full value for the securities. Furthermore, as of September 30, 2013, management does not intend to sell an impaired security and it is not more than likely that it will be required to sell the security before the recovery of its amortized cost basis. The unrealized losses on debt securities are primarily the result of interest rate changes, credit spread widening on agency-issued mortgage related securities, general financial market uncertainty and unprecedented market volatility. These conditions will not prohibit the Company from receiving its contractual principal and interest payments on its debt securities. The fair value is expected to recover as the securities approach their maturity date or repricing date. As of September 30, 2013, management believes the unrealized losses detailed in the table above are temporary and no impairment loss has been recognized in the Company's consolidated income statement. Should the impairment of any of these securities become other-than-temporary, the cost basis of the investment will be reduced and the resulting loss recognized in net income in the period of the other-than-temporary impairment is identified, while any noncredit loss will be recognized in other comprehensive income.

At September 30, 2013, the book value of the Company's five pooled trust preferred securities totaled $4.2 million with an estimated fair value of $2.3 million. All of these securities are mezzanine tranches. Pooled trust preferred securities represent beneficial interests in securitized financial assets that the Company analyzes within the scope of ASC 320, "Investments-Debt and Equity Securities" and are evaluated quarterly for other-than-temporary-impairment ("OTTI"). Management performs an analysis of OTTI utilizing its internal methodology as described below to estimate expected cash flows to be received in the future. The Company reviews each of its pooled trust preferred securities to determine if an OTTI charge would be recognized in current earnings in accordance with ASC 320, "Investments-Debt and Equity Securities". There is a risk that continued collateral deterioration could cause the Company to recognize additional OTTI charges in earnings in the future.

When evaluating pooled trust preferred securities for OTTI, the Company determines a credit related portion and a noncredit related portion. The credit related portion is recognized in earnings and represents the difference between the present value of expected future cash flows and the amortized cost basis of the security. The noncredit related portion is recognized in other comprehensive income, and represents the difference between the book value and the fair value of the security less the amount of the credit related impairment. The determination of whether it is probable that an adverse change in estimated cash flows has occurred is evaluated by comparing estimated cash flows to those previously projected as further described below. The Company considers this process to be its primary evidence when determining whether credit related OTTI exists. The results of these analyses are significantly affected by other variables such as the estimate of future cash flows, credit worthiness of the underlying issuers and determination of the likelihood of defaults of the underlying collateral.

The Company utilizes a third party model to compute the present value of expected cash flows which considers the structure and term of each of the five respective pooled trust preferred securities and the financial condition of the underlying issuers. Specifically, the third party model details interest rates, principal balances of note classes and underlying issuers, the timing and amount of interest and principal payments of the underlying issuers, and the allocation of the payments to the note classes. The current estimate of expected cash flows is based on the most recent trustee reports and any other relevant market information including announcements of interest payment deferrals or defaults of underlying trust preferred securities. For issuing banks that have defaulted, management generally assumes no recovery. For issuing banks that have deferred its interest payments, management excludes the collateral balance associated with these banks and assumes no recoveries of such collateral balance in the future. The exclusion of such issuing banks in a current deferral position is based on such bank experiencing a certain level of financial difficulty that raises doubt about its ability to satisfy its contractual debt obligation, and accordingly, the Company excludes the associated collateral balance from its estimate of expected cash flows. Other assumptions used in the estimate of expected cash flows include expected future default rates and prepayments. Specifically, the model assumes annual prepayments of 1.0% with 100% at maturity and assumes 150 basis points of additional annual defaults from banks that are currently not in default or deferral. In addition, the model assumes no recoveries except for one trust preferred security which assumes that one of the banks currently deferring will cure such positions. Management compares the present value of expected cash flows to those previously projected to determine if an adverse change in cash flows has occurred. If an adverse change in cash flows has occurred, management determines the credit loss to be recognized in the current period and the portion related to noncredit factors to be recognized in other comprehensive income.

The following table presents a progression of the credit loss component of OTTI on debt and equity securities recognized in earnings during the nine months ended September 30, 2013 and for the year ended December 31, 2012 (in thousands). The credit loss component represents the difference between the present value of expected future cash flows and the amortized cost basis of the security. The credit component of OTTI recognized in earnings during a period is presented in two parts based upon whether the credit impairment in the current period is the first time the security was credit impaired (initial credit impairment) or if there is additional credit impairment on a security that was credit impaired in previous periods.

Table of Contents

	Debt Securities	Equity Securities	Total
Balance at January 1, 2012	$20,610	$6,048	$26,658
Additions:			
Initial credit impairment	—	—	—
Additional credit impairment	576	—	576
Deductions:			
Called	—	(1,235)	(1,235)
Balance at December 31, 2012	21,186	4,813	25,999
Additions:			
Initial credit impairment	—	—	—
Additional credit impairment	—	—	—
Deductions:			
Called	—	—	—
Balance at September 30, 2013	$21,186	$4,813	$25,999

The following table presents additional information about the Company’s trust preferred securities with a credit rating of below investment grade as of September 30, 2013 (dollars in thousands):

Deal Name	Type	Class	Original Cost	Amortized Cost	Fair Value	Difference (1)	Lowest Credit Rating	# of issuers currently performing	Actual deferrals/defaults (as a % of original dollar)	Expected deferrals/defaults (as a % of remaining of performing collateral)	Excess Subordination as a Percentage of Current Performing Collateral (4)
	Pooled trust preferred securities:										
	Other-than-temporarily impaired										
	Available for Sale:										
P1	Pooled	Mezz	$827	$268	$368	100	Caa3	7	19.5 %	21.0 % (2)	52.5 %
P2	Pooled	Mezz	3,279	436	1,252	816	Ca	6	22.3 %	5.2 % (2)	23.4 %
P3 (5)	Pooled	Mezz	2,962	1,419	365	(1,054)	Caa3	22	25.5 %	8.2 % (2)	12.9 %
P4 (6)	Pooled	Mezz	4,060	400	130	(270)	Ca	9	19.2 %	7.1 % (3)	22.8 %
P5	Pooled	Mezz	6,228	826	457	(369)	Ca	9	26.0 %	21.0 % (2)	24.7 %
	Held to Maturity:										
P6	Pooled	Mezz	1,599	—	737	737	Caa3	7	19.5 %	21.0 % (2)	52.5 %
P7	Pooled	Mezz	4,354	—	1,669	1,669	Ca	6	22.3 %	5.2 % (2)	23.4 %
	Single issuer trust preferred securities										
	Available for sale:										
S5	Single		261	235	289	54	NR	1	— %	— %	
	Held to Maturity:										
S9	Single		4,000	3,994	4,000	6	NR	1	— %	— %	

(1)

The differences noted consist of unrealized gains (losses) recorded at September 30, 2013 and noncredit other-than-temporary impairment losses recorded subsequent to April 1, 2009 that have not been reclassified as credit losses.

(2) Performing collateral is defined as total collateral minus all collateral that has been called, is currently deferring, or currently in default. This model for this security assumes that all collateral that is currently deferring will default with a zero recovery rate. The underlying issuers can cure, thus this bond could recover at a higher percentage upon default than zero.

(3) Performing collateral is defined as total collateral minus all collateral that has been called, is currently deferring, or currently in default. The model for this security assumes that one of the banks that is currently deferring will cure. If additional underlying issuers cure, this bond could recover at a higher percentage.

(4) Excess subordination is defined as the additional defaults/deferrals necessary in the next reporting period to deplete the entire credit enhancement (excess interest and over-collateralization) beneath our tranche within each pool to the point that would cause a "break in yield." This amount assumes that all currently performing collateral continues to perform. A break in yield means that our security would not be expected to receive all the contractual cash flows (principal and interest) by maturity. The "percent of current performing collateral" is the ratio of the "excess subordination amount" to current performing collateral—a higher percent means there is more excess subordination to absorb additional defaults/deferrals, and the better our security is protected from loss.

(5) No other-than-temporary impairment losses were recognized during the nine months ended September 30, 2013. Other-than-temporary impairment losses of $11,000 were recognized during the year ended December 31, 2012.

(6) No other-than-temporary impairment losses were recognized during the nine months ended September 30, 2013. Other-than-temporary impairment losses of $565,000 were recognized during the year ended December 31, 2012.

Table of Contents

The amortized cost and estimated fair value of debt securities at September 30, 2013, by contractual maturity, are shown in the following table (in thousands). Expected maturities will differ from contractual maturities because the issuers of the securities may have the right to prepay obligations without prepayment penalties. Mortgage-backed securities have been allocated to their respective maturity groupings based on their contractual maturity.

	Cost	Estimated Fair Value
Securities Available-for-Sale		
Due in one year or less	$5,566	$5,581
Due after one year through five years	24,206	24,677
Due after five years through ten years	36,483	37,258
Due after ten years	258,876	255,268
	$325,131	$322,784
Securities Held-to-Maturity		
Due in one year or less	$—	$—
Due after one year through five years	—	—
Due after five years through ten years	—	—
Due after ten years	3,994	6,406
	$3,994	$6,406

Gross gains and gross losses realized by the Company from investment security transactions are summarized in the table below (in thousands). The specific identification method is used to determine the cost basis of securities sold.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Gross realized gains	$—	$830	$93	$1,776
Gross realized losses	—	(100)	—	(246)
Net investment security gains	$—	$730	$93	$1,530

The carrying value of securities pledged to secure public deposits and for other purposes as required or permitted by law approximated $266 million and $228 million at September 30, 2013 and December 31, 2012, respectively.

Note E –Loans

The following summarizes the Company's major classifications for loans (in thousands):

	September 30, 2013	December 31, 2012
Residential real estate	$1,188,841	$1,031,435
Home equity – junior liens	140,887	143,110
Commercial and industrial	151,185	108,739
Commercial real estate	1,022,278	821,970
Consumer	50,757	36,564
DDA overdrafts	4,508	4,551
Gross loans	2,558,456	2,146,369
Allowance for loan losses	(20,606)	(18,809)
Net loans	$2,537,850	$2,127,560

Construction loans of $14.8 million and $15.4 million are included within residential real estate loans at September 30, 2013 and December 31, 2012, respectively. Construction loans of $17.4 million and $15.4 million are included within commercial real estate loans at September 30, 2013 and December 31, 2012, respectively. The Company’s commercial and residential real estate construction loans are primarily secured by real estate within the Company’s principal markets. These loans were originated

Table of Contents

under the Company's loan policy, which is focused on the risk characteristics of the loan portfolio, including construction loans. Adequate consideration has been given to these loans in establishing the Company's allowance for loan losses.

The information in the following tables related to the Community acquisition are estimated amounts, based on management's assumptions. Once the purchase price allocation is finalized, actual results could be significantly different than those assumed below.

The following table details the loans acquired in conjunction with the Virginia Savings and Community acquisitions (in thousands):

	Virginia Savings	Community	Total
September 30, 2013			
Outstanding loan balance	$52,640	$288,117	$340,757
Credit-impaired loans:			
Carrying value	4,248	24,958	29,206
Contractual principal and interest	5,253	40,896	46,149
December 31, 2012			
Outstanding loan balance	$65,219	$—	$65,219
Credit-impaired loans:			
Carrying value	7,018	—	7,018
Contractual principal and interest	10,759	—	10,759

Changes in the accretable yield of the credit-impaired loans for the nine months ended September 30, 2013 is as follows (in thousands):

	Virginia Savings		Community		Total	
	Accretable Yield	Carrying Amount of Loans	Accretable Yield	Carrying Amount of Loans	Accretable Yield	Carrying Amount of Loans
Balance at the beginning of the period	$1,823	$7,018	$—	$—	$1,823	$7,018
Additions	—	—	5,587	31,790	5,587	31,790
Accretion	(844)	844	(1,665)	1,665	(2,509)	2,509
Net reclassifications to accretable yield from non-accretable yield	889	—	—	—	889	—
Payments received, net	—	(3,585)	—	(8,497)	—	(12,082)
Disposals	(604)	(29)	(344)	—	(948)	(29)
Balance at the end of period	$1,264	$4,248	$3,578	$24,958	$4,842	$29,206

Increases in expected cash flow subsequent to the acquisition are recognized first as a reduction of any previous impairment, then prospectively through adjustment of the yield on the loans or pools over its remaining life, while decreases in expected cash flows are recognized as impairment through a provision for loan loss and an increase in the allowance for purchased credit-impaired loans.

Note F – Allowance For Loan Losses

Management systematically monitors the loan portfolio and the adequacy of the allowance for loan losses on a quarterly basis to provide for probable losses inherent in the portfolio. Management assesses the risk in each loan type based on historical trends, the general economic environment of its local markets, individual loan performance and other relevant factors.

Individual credits are selected throughout the year for detailed loan reviews, which are utilized by management to assess the risk in the portfolio and the adequacy of the allowance. Due to the nature of commercial lending, evaluation of the adequacy

Table of Contents

of the allowance as it relates to these types of loan types is often based more upon specific credit reviews, with consideration given to the potential impairment of certain credits and historical loss rates, adjusted for economic conditions and other inherent risk factors.

The following summarizes the activity in the allowance for loan loss, by portfolio segment, for the nine months ended September 30, 2013 and 2012 (in thousands). The following also presents the balance in the allowance for loan loss disaggregated on the basis of the Company's impairment measurement method and the related recorded investment in loans, by portfolio segment, as of September 30, 2013 and December 31, 2012 (in thousands).

Table of Contents

	Commercial & Industrial	Commercial Real Estate	Residential Real Estate	Home equity	Consumer	DDA Overdrafts	Total
Nine months ended September 30, 2013							
Allowance for loan loss							
Beginning balance	$498	$10,440	$5,229	$1,699	$81	$862	$18,809
Charge-offs	772	803	1,598	278	326	1,102	4,879
Recoveries	51	669	137	—	242	674	1,773
Provision	1,460	201	2,481	268	79	414	4,903
Ending balance	$1,237	$10,507	$6,249	$1,689	$76	$848	$20,606
Nine months ended September 30, 2012							
Allowance for loan loss							
Beginning balance	$590	$11,666	$3,591	$2,773	$88	$701	$19,409
Charge-offs	126	2,860	746	989	148	1,128	5,997
Recoveries	12	100	15	12	90	745	974
Provision	45	1,684	955	1,250	75	591	4,600
Ending balance	$521	$10,590	$3,815	$3,046	$105	$909	$18,986
As of September 30, 2013							
Allowance for loan loss							
Evaluated for impairment:							
Individually	$—	$880	$—	$—	$—	$—	$880
Collectively	1,237	9,537	6,249	1,689	76	848	19,636
Acquired with deteriorated credit quality	—	90	—	—	—	—	90
Total	$1,237	$10,507	$6,249	$1,689	$76	$848	$20,606
Loans							
Evaluated for impairment:							
Individually	$—	$12,082	$461	$297	$—	$—	$12,840
Collectively	148,262	987,711	1,186,995	138,285	50,649	4,508	2,516,410
Acquired with deteriorated credit quality	2,923	22,485	1,385	2,305	108	—	29,206
Total	$151,185	$1,022,278	$1,188,841	$140,887	$50,757	$4,508	$2,558,456

As of December 31, 2012							
Allowance for loan loss							
Evaluated for impairment:							
Individually	$—	$—	$—	$—	$—	$—	$—
Collectively	498	10,440	5,229	1,699	81	862	18,809
Acquired with deteriorated credit quality	—	—	—	—	—	—	—
Total	$498	$10,440	$5,229	$1,699	$81	$862	$18,809
Loans							
Evaluated for impairment:							
Individually	$—	$9,912	$469	$298	$—	$—	$10,679
Collectively	107,044	807,060	1,030,840	142,724	36,453	4,551	2,128,672
Acquired with deteriorated credit quality	1,695	4,998	126	88	111	—	7,018
Total	$108,739	$821,970	$1,031,435	$143,110	$36,564	$4,551	$2,146,369

Table of Contents

Credit Quality Indicators

All commercial loans within the portfolio are subject to internal risk grading. All non-commercial loans are evaluated based on payment history. The Company's internal risk ratings for commercial loans are: Pass, Special Mention, Substandard and Doubtful. Each internal risk rating is defined in the loan policy using the following criteria: balance sheet yields, ratios and leverage, cash flow spread and coverage, prior history, capability of management, market position/industry, potential impact of changing economic, legal, regulatory or environmental conditions, purpose structure, collateral support, and guarantor support. Risk grades are generally assigned by the primary lending officer and are periodically evaluated by the Company's internal loan review process. Based on an individual loan's risk grade, estimated loss percentages are applied to the outstanding balance of the loan to determine the amount of probable loss.

The Company categorizes loans into risk categories based on relevant information regarding the customer's debt service ability, capacity, overall collateral position along with other economic trends, and historical payment performance. The risk grades for each credit are updated when the Company receives current financial information, the loan is reviewed by the Company's internal loan review/credit administration departments, or the loan becomes delinquent or impaired. The risk grades are updated a minimum of annually for loans rated exceptional, good, acceptable, or pass/watch. Loans rated special mention, substandard or doubtful are reviewed at least quarterly. The Company uses the following definitions for its risk ratings:

Risk Rating	Description
Pass ratings:	
(a) Exceptional	Loans classified as exceptional are secured with liquid collateral conforming to the internal loan policy. Loans rated within this category pose minimal risk of loss to the bank and the risk grade within this pool of loans is generally updated on an annual basis.
(b) Good	Loans classified as good have similar characteristics that include a strong balance sheet, satisfactory debt service coverage ratios, strong management and/or guarantors, and little exposure to economic cycles. Loans within this category are generally reviewed on an annual basis. Loans in this category generally have a low chance of loss to the bank.
(c) Acceptable	Loans classified as acceptable have acceptable liquidity levels, adequate debt service coverage ratios, experienced management, and have average exposure to economic cycles. Loans within this category generally have a low risk of loss to the bank.
(d) Pass/watch	Loans classified as pass/watch have erratic levels of leverage and/or liquidity, cash flow is volatile and the borrower is subject to moderate economic risk. A borrower in this category poses a low to moderate risk of loss to the bank.
Special mention	