NBT BANCORP INC
Form 10-Q
August 09, 2012

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, 2012.
OR
¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from ________ to ________.

COMMISSION FILE NUMBER 0-14703

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 ¨

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 ¨

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 ¨ 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

As of July 31, 2012, there were 33,735,779 shares outstanding of the Registrant's common stock, $0.01 par value per share.

NBT BANCORP INC.
FORM 10-Q--Quarter Ended June 30, 2012

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Item 1 – FINANCIAL STATEMENTS

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

(In thousands, except share and per share data)	June 30, 2012	December 31, 2011
Assets		
Cash and due from banks	$114,441	$ 128,517
Short-term interest bearing accounts	24,723	864
Securities available for sale, at fair value	1,221,706	1,244,619
Securities held to maturity (fair value $65,556 and $72,198, respectively)	64,387	70,811
Trading securities	3,641	3,062
Federal Reserve and Federal Home Loan Bank stock	28,706	27,020
Loans	4,161,214	3,800,203
Less allowance for loan losses	70,734	71,334
Net loans	4,090,480	3,728,869
Premises and equipment, net	76,906	74,541
Goodwill	151,628	132,029
Intangible assets, net	18,191	18,194
Bank owned life insurance	79,215	77,626
Other assets	93,544	92,254
Total assets	$5,967,568	$ 5,598,406
Liabilities		
Demand (noninterest bearing)	$1,152,646	$ 1,052,906
Savings, NOW, and money market	2,483,683	2,381,116
Time	1,052,578	933,127
Total deposits	4,688,907	4,367,149
Short-term borrowings	212,203	181,592
Long-term debt	367,147	370,344
Trust preferred debentures	75,422	75,422
Other liabilities	57,384	65,789
Total liabilities	5,401,063	5,060,296
Stockholders' equity		
Preferred stock, $0.01 par value. Authorized 2,500,000 shares at June 30, 2012 and December 31, 2011	-	-
Common stock, $0.01 par value. Authorized 100,000,000 shares at June 30, 2012 and 50,000,000 December 31, 2011; issued 39,305,131 at June 30, 2012 and 38,035,539 at December 31, 2011	393	380
Additional paid-in-capital	345,184	317,329
Retained earnings	343,460	329,981
Accumulated other comprehensive loss	(5,207)	(6,104)
Common stock in treasury, at cost, 5,569,345 and 4,878,829 shares at June 30, 2012 and December 31, 2011, respectively	(117,325)	(103,476)
Total stockholders' equity	566,505	538,110
Total liabilities and stockholders' equity	$5,967,568	$ 5,598,406

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,		Six months ended June 30,	
	2012	2011	2012	2011
Interest, fee, and dividend income				
Interest and fees on loans	$50,509	$51,126	$100,717	$101,986
Securities available for sale	7,108	7,947	14,474	15,851
Securities held to maturity	617	745	1,257	1,545
Other	413	440	805	933
Total interest, fee, and dividend income	58,647	60,258	117,253	120,315
Interest expense				
Deposits	4,834	6,051	9,977	12,338
Short-term borrowings	48	52	89	110
Long-term debt	3,580	3,591	7,161	7,162
Trust preferred debentures	434	400	883	1,289
Total interest expense	8,896	10,094	18,110	20,899
Net interest income	49,751	50,164	99,143	99,416
Provision for loan losses	4,103	6,021	8,574	9,986
Net interest income after provision for loan losses	45,648	44,143	90,569	89,430
Noninterest income				
Insurance and other financial services revenue	5,279	5,025	11,433	10,798
Service charges on deposit accounts	4,571	5,455	8,912	10,527
ATM and debit card fees	3,063	2,928	6,025	5,596
Retirement plan administration fees	2,411	2,268	4,744	4,439
Trust	2,312	2,258	4,441	4,294
Bank owned life insurance	618	660	1,589	1,695
Net securities gains	97	59	552	86
Other	2,331	1,208	6,042	2,552
Total noninterest income	20,682	19,861	43,738	39,987
Noninterest expense				
Salaries and employee benefits	24,992	24,035	51,717	49,039
Occupancy	4,222	3,987	8,713	8,509
Data processing and communications	3,431	3,117	6,689	6,031
Professional fees and outside services	2,388	2,088	5,113	4,154
Equipment	2,409	2,180	4,789	4,370
Office supplies and postage	1,574	1,342	3,245	2,887
FDIC expenses	942	965	1,873	2,461
Advertising	805	1,033	1,607	1,601
Amortization of intangible assets	841	771	1,660	1,504
Loan collection and other real estate owned	799	443	1,437	1,162
Merger expenses	826	-	1,337	-
Other	4,161	3,196	7,684	6,500
Total noninterest expense	47,390	43,157	95,864	88,218
Income before income tax expense	18,940	20,847	38,443	41,199
Income tax expense	5,683	6,192	11,536	12,237
Net income	$13,257	$14,655	$26,907	$28,962
Earnings per share				
Basic	$0.40	$0.43	$0.81	$0.85
Diluted	$0.40	$0.43	$0.80	$0.84

See accompanying notes to unaudited interim consolidated financial statements.

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Consolidated Statements of Comprehensive Income (unaudited) (In thousands)	Three months ended June 30,		Six months ended June 30,	
	2012	2011	2012	2011
Net income	$13,257	$14,655	$26,907	$28,962
Other comprehensive income, net of tax				
Unrealized net holding (losses) gains arising during the period (pre-tax amounts of ($309), $10,392, $335 and $7,741)	(185)	6,274	201	4,672
Reclassification adjustment for net gains related to securities available for sale included in net income (pre-tax amounts of $98, $59, $552 and $86)	(58)	(36)	(331)	(52)
Pension and other benefits:				
Amortization of prior service cost and actuarial gains (pre-tax amounts of $856, $416, $1,713 and $831)	511	251	1,027	502
Total other comprehensive income	268	6,489	897	5,122
Comprehensive income	$13,525	$21,144	$27,804	$34,084

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, 2010	$380	$314,023	$299,797	$ (5,335)	$(75,293)	$533,572
Net income	-	-	28,962	-	-	28,962
Cash dividends - $0.40 per share	-	-	(13,752)	-	-	(13,752)
Purchase of 976,190 treasury shares	-	-	-	-	(21,164)	(21,164)
Net issuance of 61,432 shares to employee benefit plans and other stock plans, including tax benefit	-	(291)	(134)	-	1,225	800
Stock-based compensation	-	1,723	-	-	-	1,723
Other comprehensive income	-	-	-	5,122	-	5,122
Balance at June 30, 2011	$380	$315,455	$314,873	$ (213)	$(95,232)	$535,263
Balance at December 31, 2011	$380	$317,329	$329,981	$ (6,104)	$(103,476)	$538,110
Net income	-	-	26,907	-	-	26,907
Cash dividends - $0.40 per share	-	-	(13,232)	-	-	(13,232)
	-	-	-	-	(15,490)	(15,490)

Purchase of 769,568 treasury shares						
Net issuance of 1,269,592 shares for acquisition	13	25,811	-	-	-	25,824
Net issuance of 79,052 shares to employee benefit plans and other stock plans, including tax benefit	-	(753)	(196)	-	1,641	692
Stock-based compensation	-	2,797	-	-	-	2,797
Other comprehensive income	-	-	-	897	-	897
Balance at June 30, 2012	$393	$345,184	$343,460	$ (5,207)	$(117,325)	$566,505

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, 2012	2011
Operating activities		
Net income	$26,907	$28,962
Adjustments to reconcile net income to net cash provided by operating activities		
Provision for loan and lease losses	8,574	9,986
Depreciation and amortization of premises and equipment	3,020	2,652
Net accretion on securities	1,197	512
Amortization of intangible assets	1,660	1,504
Stock based compensation	2,797	1,723
Bank owned life insurance income	(1,589)	(1,695)
Purchases of trading securities	(657)	(353)
Unrealized losses (gains) in trading securities	78	(115)
Deferred income tax benefit	(1,794)	(4,003)
Proceeds from sales of loans held for sale	28,774	2,477
Originations and purchases of loans held for sale	(34,182)	(875)
Net gains on sales of loans held for sale	(894)	-
Net security gains	(552)	(86)
Net gain on sales of other real estate owned	(417)	(461)
Net decrease in other assets	11,099	2,696
Net increase (decrease) in other liabilities	(10,899)	158
Net cash provided by operating activities	33,122	43,082
Investing activities		
Net cash provided by (used in) acquisitions	53,121	(1,000)
Securities available for sale:		
Proceeds from maturities, calls, and principal paydowns	205,390	247,959
Proceeds from sales	1,791	118
Purchases	(185,112)	(268,154)
Securities held to maturity:		
Proceeds from maturities, calls, and principal paydowns	16,655	29,288
Purchases	(9,858)	(9,192)
Net increase in loans	(142,433)	(67,474)
Net increase in Federal Reserve and FHLB stock	(672)	(179)
Purchases of premises and equipment	(2,769)	(2,112)
Proceeds from sales of other real estate owned	1,661	953
Net cash (used in) provided by investing activities	(62,226)	(69,793)
Financing activities		
Net increase (decrease) in deposits	39,653	(19,739)
Net increase in short-term borrowings	30,611	16,524
Repayments of long-term debt	(3,347)	(2,140)
Issuance of long-term debt	-	156
Excess tax benefit from exercise of stock options	2	33
Proceeds from the issuance of shares to employee benefit plans and other stock plans	690	767
Purchase of treasury stock	(15,490)	(21,164)
Cash dividends and payment for fractional shares	(13,232)	(13,752)
Net cash used in financing activities	38,887	(39,315)
Net decrease in cash and cash equivalents	9,783	(66,026)

Cash and cash equivalents at beginning of period	129,381	168,792
Cash and cash equivalents at end of period	$139,164	$102,766

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Supplemental disclosure of cash flow information		
Cash paid during the period for:		
Interest	$18,245	$21,120
Income taxes paid	14,122	14,834
Noncash investing activities:		
Loans transferred to OREO	$889	$625
Acquisitions:		
Fair value of assets acquired	$258,256	$3,460
Fair value of liabilities assumed	285,403	3,426
Fair value of debt issued in purchase combination	150	2,460

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, 2012

Note 1. Description of Business

NBT Bancorp Inc. (the “Registrant”) is a registered financial holding company incorporated in the State of Delaware in 1986, with its principal headquarters located in Norwich, New York. The Registrant is the parent holding company of NBT Bank, N.A. (the “Bank”), NBT Financial Services, Inc. (“NBT Financial”), NBT Holdings, Inc. (“NBT Holdings”), CNBF Capital Trust I, NBT Statutory Trust I and NBT Statutory Trust II (the “Trusts”). Through the Bank, the Company is focused on community banking operations. Through NBT Financial, the Company operates EPIC Advisors, Inc. (“EPIC”), a retirement plan administrator. Through NBT Holdings, the Company operates Mang Insurance Agency, LLC (“Mang”), a full-service insurance agency. The Trusts were organized to raise additional regulatory capital and to provide funding for certain acquisitions. The Registrant’s primary business consists of providing commercial banking and financial services to customers in its market area. The principal assets of the Registrant are all of the outstanding shares of common stock of its direct subsidiaries, and its principal sources of revenue are the management fees and dividends it receives from the Bank, NBT Financial, and NBT Holdings.

The Bank is a full service commercial bank formed in 1856, which provides a broad range of financial products to individuals, corporations and municipalities throughout the upstate New York, northeastern Pennsylvania, northwestern Vermont, western Massachusetts, and southern New Hampshire market areas.

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.” 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.

Note 3. Acquisition

On June 8, 2012, the Company acquired all of the outstanding common shares of Hampshire First Bank ("Hampshire First"). The five banking centers operated by Hampshire First located in Manchester, Londonderry, Nashua, Keene and Portsmouth, New Hampshire will continue to do business under the Hampshire First name as a division of the Bank. This business combination is a strategic extension of the Company’s franchise and the combination was negotiated between the companies and was approved unanimously by their boards of directors.

Hampshire First shareholders received approximately 1.3 million shares of the Company’s common stock and $17.2 million in cash. On the acquisition date, Hampshire First had approximately 2.8 million outstanding common shares. Under the terms of the merger agreement between the Company, the Bank and Hampshire First, the Company paid $15.00 per share for 35% of the outstanding Hampshire First common shares and the remaining 65% of outstanding Hampshire First shares received 0.7019 shares of the Company’s common stock for each share. Approximately 1.3 million shares of the Company’s common stock issued in this exchange were valued at $20.34 per share based on the average of the daily closing price of the Company’s stock for the ten trading days immediately prior to June 8, 2012. The Company paid $2.6 million in cash to retire outstanding Hampshire First stock options and warrants.

The results of Hampshire First's operations are included in the Consolidated Statements of Income from the date of acquisition. In connection with the merger, the consideration paid, the assets acquired, and the liabilities assumed were recorded at fair value on the date of acquisition, as summarized in the following tables, in thousands, as of June 8, 2012:

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Consideration Paid:	
NBT Bancorp common stock issued to Hampshire First common stockholders	$25,824
Cash consideration paid to Hampshire First common stockholders	14,616
Cash consideration paid for Hampshire First employee stock options and warrants	2,583
Total consideration paid	$43,023
Recognized Amounts of Identifiable Assets Acquired and (Liabilities Assumed), At Fair Value:	
Cash and short term investments	$22,149
Loans	219,815
Federal Home Loan Bank common stock	1,014
Core deposit intangibles	797
Other assets	12,535
Deposits	(228,198)
Borrowings	(41)
Other liabilities	(2,848)
Total identifiable net assets	$25,223
Goodwill	$17,800

The fair values for most loans acquired from Hampshire were estimated using cash flow projections based on the remaining maturity and repricing terms. Cash flows were adjusted by estimating future credit losses and the rate of prepayments. Projected monthly cash flows were then discounted to present value using a risk-adjusted market rate for similar loans. To estimate the fair value of problem loans, we analyzed the value of the underlying collateral of the loans, assuming the fair values of the loans were derived from the eventual sale of the collateral. We discounted those values using market derived rates of return, with consideration given to the period of time and costs associated with the foreclosure and disposition of the collateral. There was no carryover of Hampshire First's allowance for credit losses associated with the loans we acquired as the loans were initially recorded at fair value.

Information about the acquired loan portfolio as of June 8, 2012 is as follows (in thousands):

Contractually required principal and interest at acquisition	$226,631
Contractual cash flows not expected to be collected (nonaccretable discount)	(6,971)
Expected cash flows at acquisition	219,660
Interest component of expected cash flows (accretable discount)	155
Fair value of acquired loans	$219,815

The core deposit intangible asset recognized as part of the Hampshire First merger is being amortized over its estimated useful life of approximately ten years utilizing an accelerated method.

The goodwill is not amortized for book purposes and is not deductible for tax purposes.

The fair value of savings and transaction deposit accounts acquired from Hampshire was assumed to approximate the carrying value as these accounts have no stated maturity and are payable on demand. Certificates of deposit were valued by comparing the contractual cost of the portfolio to an identical portfolio bearing current market rates. The projected cash was calculated by discounting their contractual cash flows at a market rate for a certificate of deposit with a corresponding maturity.

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Note 4. Use of Estimates

Preparing financial statements in conformity with accounting principles generally accepted in the United States of America (U.S. GAAP) requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period, as well as the disclosures provided. Actual results could differ from those estimates. Estimates associated with the allowance for loan losses, other real estate owned ("OREO"), income taxes, pension expense, fair values of financial instruments and status of contingencies are particularly susceptible to material change in the near term.

The allowance for loan losses is the amount which, in the opinion of management, is necessary to absorb probable losses inherent in the loan portfolio. The allowance is determined based upon numerous considerations, including local and national economic conditions, the growth and composition of the loan portfolio with respect to the mix between the various types of loans and their related risk characteristics, a review of the value of collateral supporting the loans, comprehensive reviews of the loan portfolio by the independent loan review staff and management, as well as consideration of volume and trends of delinquencies, nonperforming loans, and loan charge-offs. As a result of the review of these factors and historical and current indicators, required additions or reductions to the allowance for loan losses are made periodically by charges or credits to the provision for loan losses.

The allowance for loan losses related to impaired loans is based on discounted cash flows using the loan's initial effective interest rate or the fair value of the collateral for certain loans where repayment of the loan is expected to be provided solely by the underlying collateral (collateral dependent loans). The Company's impaired loans are generally collateral dependent loans. The Company considers the estimated cost to sell, on a discounted basis, when determining the fair value of collateral in the measurement of impairment if those costs are expected to reduce the cash flows available to repay or otherwise satisfy the loans.

Management believes that the allowance for loan losses is adequate. While management uses available information to recognize loan losses, future additions or reductions to the allowance for loan losses may be necessary based on changes in economic conditions or changes in the values of properties securing loans in the process of foreclosure. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Company's allowance for loan losses. Such agencies may require the Company to recognize additions to the allowance for loan losses based on their judgments about information available to them at the time of their examination which may not be currently available to management. 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.

OREO consists of properties acquired through foreclosure or by acceptance of a deed in lieu of foreclosure. These assets are recorded at the lower of fair value of the asset acquired less estimated costs to sell or "cost" (cost is defined as the fair value less costs to sell at initial foreclosure). At the time of foreclosure, or when foreclosure occurs in-substance, the excess, if any, of the loan over the fair value of the assets received, less estimated selling costs, is charged to the allowance for loan losses and any subsequent valuation write-downs are charged to other expense. Operating costs associated with the properties are charged to expense as incurred. Gains on the sale of OREO are included in income when title has passed and the sale has met the minimum down payment requirements prescribed by U.S. GAAP.

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Income taxes are accounted for under the asset and liability method. The Company files consolidated tax returns on the accrual basis. Deferred income taxes are recognized for the future tax consequences and benefits attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. Realization of deferred tax assets is dependent upon the generation of future taxable income or the existence of sufficient taxable income within the available carryback period. A valuation allowance is provided when it is more likely than not that some portion of the deferred tax asset will not be realized. Based on available carrybacks and expected future income, gross deferred tax assets will ultimately be realized and a valuation allowance was not deemed necessary at June 30, 2012 or December 31, 2011. The effect of a change in tax rates on deferred taxes is recognized in income in the period that includes the enactment date. Uncertain tax positions are recognized only when it is more likely than not (likelihood of greater than 50%), based on technical merits, that the position would be sustained upon examination by taxing authorities. Tax positions that meet the more likely than not threshold are measured using a probability-weighted approach as the largest amount of tax benefit that is greater than 50% likely of being realized upon settlement.

Management is required to make various assumptions in valuing its pension assets and liabilities. These assumptions include the expected long-term rate of return on plan assets, the discount rate, and the rate of increase in future compensation levels. Changes to these assumptions could impact earnings in future periods. The Company takes into account the plan asset mix, funding obligations, and expert opinions in determining the various assumptions used to compute pension expense. The Company also considers relevant indices and market interest rates in selecting an appropriate discount rate. A cash flow analysis for expected benefit payments from the plan is performed each year to assist in selecting the discount rate. In addition, the Company reviews expected inflationary and merit increases to compensation in determining the expected rate of increase in future compensation levels.

Management is required to make various assumptions in determining the fair values of financial instruments. Fair value estimates are made at a specific point in time, based on relevant market information and information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale at one time the Company’s entire holdings of a particular financial instrument. Because no market exists for a significant portion of the Company’s financial instruments, fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments, and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

Management is required to make various assumptions in determining the credit risk involved in issuing contingent obligations such as standby letters of credit, commercial letters of credit, and other lines of credit. Since commitments to extend credit and unused lines of credit may expire without being fully drawn upon, this amount does not necessarily represent future cash commitments. Based on historical experience and economic factors, the Company makes estimates of future cash commitments from these contingent obligations to determine their fair value and establish an allowance if necessary.

Beginning in June 2012 with the acquisition of Hampshire First Bank, the Bank offers interest rate swap agreements to its customers. These agreements allow the Bank’s customers to effectively fix the interest rate on a variable rate loan by entering into a separate agreement. Simultaneous with the execution of such an agreement with a customer, the Bank enters into a matching interest rate swap agreement with an unrelated third party provider, which allows the Bank to continue to receive the historical variable rate under the loan agreement with the customer. The agreement with the third party is not a hedge contract therefore changes in fair value are recorded through earnings. Assets and liabilities associated with the agreements are recorded in other assets and other liabilities on the balance sheet. Gains and losses are recorded as other noninterest income. The Bank is not subject to any fee or penalty should the customer elect to terminate the interest rate swap agreement prior to maturity. The Bank is exposed to credit loss

equal to the fair value of the derivatives (not the notional amount of the derivatives) in the event of nonperformance by the counterparty to the interest rate swap agreements. Since the terms of the two interest rate swap agreements are identical, the impact to the Bank is limited to fees it receives from the customer. Such fees are non-refundable and are recognized when the Bank has fulfilled its obligations under each agreement, which is generally upon execution of the agreement with the Bank's customer. The Bank did not recognize any fee income for the six months ended June 30, 2012. At June 30, 2012, the Bank maintained a $1.6 million deposit with the counterparty to collateralize the swap agreements.

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Note 5. Commitments and Contingencies

The Company is a party to financial instruments in the normal course of business to meet the financing needs of its customers and to reduce its own exposure to fluctuating interest rates. These financial instruments include commitments to extend credit, unused lines of credit, and standby letters of credit. Exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to make loans and standby letters of credit is represented by the contractual amount of those instruments. The Company uses the same credit origination guidelines, portfolio maintenance and management procedures as other credit and off-balance sheet products. Commitments to extend credit and unused lines of credit totaled $873.6 million at June 30, 2012 and $764.9 million at December 31, 2011. Since commitments to extend credit and unused lines of credit may expire without being fully drawn upon, this amount does not necessarily represent future cash commitments. Collateral obtained upon exercise of the commitment is determined using management's credit evaluation of the borrower and may include accounts receivable, inventory, property, land and other items.

The Company guarantees the obligations or performance of customers by issuing standby letters of credit to third parties. These standby letters of credit are frequently issued in support of third party debt, such as corporate debt issuances, industrial revenue bonds and municipal securities. The credit risk involved in issuing standby letters of credit is essentially the same as the credit risk involved in extending loan facilities to customers, and they are subject to the same credit origination guidelines, portfolio maintenance and management procedures as other credit and off-balance sheet products. Typically, these instruments have terms of five years or less and expire unused; therefore, the total amounts do not necessarily represent future cash commitments. Standby letters of credit totaled $31.2 million at June 30, 2012 and $26.8 million at December 31, 2011. As of June 30, 2012, the fair value of standby letters of credit was not significant to the Company's consolidated financial statements.

The Company has also entered into commercial letter of credit agreements on behalf of its customers. Under these agreements, the Company, on the request of its customer, opens the letter of credit and makes a commitment to honor draws made under the agreement, whereby the beneficiary is normally the provider of goods and/or services and the Company essentially replaces the customer as the payee. The credit risk involved in issuing commercial letters of credit is essentially the same as the credit risk involved in extending loan facilities to customers, and they are subject to the same credit origination guidelines, portfolio maintenance and management procedures as other credit and off-balance sheet products. Typically, these agreements vary in terms and the total amounts do not necessarily represent future cash commitments. Commercial letters of credit totaled $9.2 million at June 30, 2012 and $15.2 million at December 31, 2011. As of June 30, 2012, the fair value of commercial letters of credit was not significant to the Company's consolidated financial statements.

Note 6. 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.

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To develop and document a systematic methodology for determining the allowance for loan losses, the Company has divided the loan portfolio into three portfolio segments, each with different risk characteristics and methodologies for assessing risk. 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 – 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 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 and is generally less liquid than real estate. To reduce the risk, management also attempts to secure real estate as collateral and obtain personal guarantees of the borrowers.

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 property which generally consists of real estate 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. The Company's underwriting analysis includes credit verification, independent appraisals, a review of the borrower's financial condition, and a detailed analysis of the borrower's underlying cash flows. These loans are typically 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. The Company's underwriting analysis includes credit verification, independent appraisals, a review of the borrower's financial condition, and a detailed analysis of the borrower's underlying cash flows. 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 $350 thousand 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.

Indirect – The Company maintains relationships with many dealers primarily in the communities that we serve. Through these relationships, the company finances the purchases of automobiles and recreational vehicles (such as campers, boats, etc.) indirectly through dealer relationships. Approximately 69% 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 borrower 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.

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 – 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. When market conditions are favorable, for longer term, fixed-rate residential mortgages without escrow, the Company retains the servicing, but sells the right to receive principal and interest to Freddie Mac. This practice allows the Company to manage interest rate risk, liquidity risk, and credit risk. 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. 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.

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Allowance for Loan Loss Calculation

Management considers the accounting policy related to the allowance for loan losses to be a critical accounting policy given the inherent uncertainty in evaluating the levels of the allowance required to cover credit losses in the portfolio and the material effect that such judgments can have on the consolidated results of operations.

For purposes of evaluating the adequacy of the allowance, the Company considers a number of significant factors that affect the collectibility 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 collectibility. 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. The following table illustrates the changes in the allowance for loan losses by portfolio segment for the three and six months ended June 30, 2012 and June 30, 2011:

Allowance for Loan Losses
(in thousands)

Three months ended June 30	Commercial Loans	Consumer Loans	Residential Real Estate Mortgages	Unallocated	Total
Balance as of March 31, 2012	$ 37,787	$ 26,790	$ 6,520	$ 237	$ 71,334
Charge-offs	(1,653)	(3,735)	(292)	-	(5,680)
Recoveries	303	667	7	-	977
Provision	1,058	3,513	(292)	(176)	4,103
Ending Balance as of June 30, 2012	$ 37,495	$ 27,235	$ 5,943	$ 61	$ 70,734
Balance as of March 31, 2011	$ 37,937	$ 26,219	$ 5,338	$ 440	$ 69,934
Charge-offs	(2,588)	(3,600)	(414)	-	(6,602)
Recoveries	474	654	3	-	1,131
Provision	3,324	2,445	446	(194)	6,021
Ending Balance as of June 30, 2011	$ 39,147	$ 25,718	$ 5,373	$ 246	$ 70,484

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Six months ended June 30	Commercial Loans	Consumer Loans	Residential Real Estate Mortgages	Unallocated	Total
Balance as of December 31, 2011	$ 38,831	$ 26,049	$ 6,249	$ 205	$ 71,334
Charge-offs	(2,783)	(7,787)	(650)	-	(11,220)
Recoveries	688	1,342	16	-	2,046
Provision	759	7,631	328	(144)	8,574
Ending Balance as of June 30, 2012	$ 37,495	$ 27,235	$ 5,943	$ 61	$ 70,734
Balance as of December 31, 2010	$ 40,101	$ 26,126	$ 4,627	$ 380	$ 71,234
Charge-offs	(5,458)	(6,893)	(513)	-	(12,864)
Recoveries	894	1,230	4	-	2,128
Provision	3,610	5,255	1,255	(134)	9,986
Ending Balance as of June 30, 2011	$ 39,147	$ 25,718	$ 5,373	$ 246	$ 70,484

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The following tables illustrate the allowance for loan losses and the recorded investment by portfolio segment as of June 30, 2012 and December 31, 2011:

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

	Commercial Loans	Consumer Loans	Residential Real b Estate Mortgages	Unallocated	Total
As of June 30, 2012					
Allowance for loan losses	$ 37,495	$27,235	$5,943	$61	$70,734
Allowance for loans individually evaluated for impairment	$ 2,724	$-	$-		$2,724
Allowance for loans collectively evaluated for impairment	$ 34,771	$27,235	$5,943	$61	$68,010
Ending balance of loans	$ 1,963,667	$1,566,756	$630,791		$4,161,214
Ending balance of loans individually evaluated for impairment	$ 13,412	$-	$-		$13,412
Ending balance of loans collectively evaluated for impairment	$ 1,950,255	$1,566,756	$630,791		$4,147,802
As of December 31, 2011					
Allowance for loan losses	$ 38,831	$26,049	$6,249	$205	$71,334
Allowance for loans individually evaluated for impairment	$ 175	$-	$-		$175
Allowance for loans collectively evaluated for impairment	$ 38,656	$26,049	$6,249	$205	$71,159
Ending balance of loans	$ 1,702,577	$1,516,115	$581,511		$3,800,203
Ending balance of loans individually evaluated for impairment	$ 6,219	$-	$-		$6,219
Ending balance of loans collectively evaluated for impairment	$ 1,696,358	$1,516,115	$581,511		$3,793,984

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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.

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

Loans on Nonaccrual Status

As of June 30, 2012

(In thousands)	June 30, 2012	December 31, 2011
Commercial Loans		
Commercial	$ 7,134	$ 1,699
Commercial Real Estate	7,364	4,868
Agricultural	2,818	3,307
Agricultural Real Estate	1,428	2,067
Business Banking	6,384	7,446
	25,128	19,387
Consumer Loans		
Indirect	1,770	1,550
Home Equity	7,848	7,931
Direct	296	378
	9,914	9,859
Residential Real Estate Mortgages	8,882	9,044
Total Nonaccrual	$ 43,924	$ 38,290

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The increase in nonaccrual commercial and commercial real estate loans from December 31, 2011 to June 30, 2012 was due primarily to one commercial relationship which moved to nonaccrual status during the first quarter. This relationship has been reviewed and was specifically reserved for by the Company during the first quarter of 2012.

The following tables set forth information with regard to past due and nonperforming loans by loan class as of June 30, 2012 and December 31, 2011:

Age Analysis of Past Due Financing Receivables
As of June 30, 2012
(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
Commercial Loans							
Commercial	$268	$49	$ -	$317	$ 7,134	$589,200	$596,651
Commercial Real Estate	506	-	-	506	7,364	1,009,260	$1,017,130
Agricultural	71	-	-	71	2,818	60,576	$63,465
Agricultural Real Estate	60	-	-	60	1,428	32,525	$34,013
Business Banking	1,759	360	-	2,119	6,384	243,905	$252,408
	2,664	409	-	3,073	25,128	1,935,466	$1,963,667
Consumer Loans							
Indirect	7,138	1,525	285	8,948	1,770	913,057	$923,775
Home Equity	4,311	1,186	1,215	6,712	7,848	558,610	$573,170
Direct	559	115	32	706	296	68,809	$69,811
	12,008	2,826	1,532	16,366	9,914	1,540,476	$1,566,756
Residential Real Estate Mortgages	1,945	965	97	3,007	8,882	618,902	$630,791
	$16,617	$4,200	$ 1,629	$22,446	$ 43,924	$4,094,844	$4,161,214

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Age Analysis of Past Due Financing Receivables
As of December 31, 2011
(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
Commercial Loans							
Commercial	$663	$50	$ -	$713	$ 1,699	$508,662	$511,074
Commercial Real Estate	1,942	-	-	1,942	4,868	828,089	834,899
Agricultural	77	13	-	90	3,307	63,140	66,537
Agricultural Real Estate	-	-	50	50	2,067	31,809	33,926
Business Banking	1,871	1,024	-	2,895	7,446	245,800	256,141
	4,553	1,087	50	5,690	19,387	1,677,500	1,702,577
Consumer Loans							
Indirect	12,141	2,584	1,283	16,008	1,550	855,545	873,103
Home Equity	5,823	1,277	954	8,054	7,931	553,660	569,645
Direct	831	191	140	1,162	378	71,827	73,367
	18,795	4,052	2,377	25,224	9,859	1,481,032	1,516,115
Residential Real Estate Mortgages	2,003	139	763	2,905	9,044	569,562	581,511
	$25,351	$5,278	$ 3,190	$33,819	$ 38,290	$3,728,094	$3,800,203

There were no material commitments to extend further credit to borrowers with nonperforming loans. Within nonaccrual loans, there are approximately $2.3 million and $4.0 million of troubled debt restructured loans at June 30, 2012 and December 31, 2011, respectively.

Impaired loans, which primarily consist of nonaccruing commercial, commercial real estate, agricultural, agricultural real estate and business banking loans were $26.9 million at June 30, 2012 and $22.4 million at December 31, 2011.

The methodology used to establish the allowance for loan losses on impaired loans incorporates specific allocations on loans analyzed individually. Classified loans with outstanding balances of $500 thousand or more 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. For impaired loans measured using the present value of expected cash flow method, 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 credit losses. At June 30, 2012, $6.2 million of the total impaired loans had a specific reserve allocation of $2.7 million compared to $.5 million of impaired loans at December 31, 2011 which had a specific reserve allocation of $0.2 million.

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The following table provides additional information on impaired loans and specific reserve allocations as of June 30, 2012 and December 31, 2011:

Impaired Loans

	June 30, 2012			December 31, 2011		
(in thousands)	Recorded Investment Balance (Book)	Unpaid Principal Balance (Legal)	Related Allowance	Recorded Investment Balance (Book)	Unpaid Principal Balance (Legal)	Related Allowance
With no related allowance recorded:						
Commercial Loans						
Commercial	$961	$1,261		$1,243	$2,723	
Commercial Real Estate	7,364	9,163		4,868	7,165	
Agricultural	2,818	3,754		3,307	4,166	
Agricultural Real Estate	1,428	1,502		2,067	2,288	
Business Banking	6,384	8,696		7,446	9,976	
Total Commercial Loans	18,955	24,376		18,931	26,318	
Consumer Loans						
Home Equity	1,801	1,899		2,000	2,103	
Residential Real Estate Mortgages	1,121	1,275		1,040	1,125	
	$21,877	$27,550		$21,971	$29,546	
With an allowance recorded:						
Commercial Loans						
Commercial	$6,173	$6,181	$2,724	$456	$808	$175
Commercial Real Estate	-	-	-	-	-	-
Agricultural	-	-	-	-	-	-
Agricultural Real Estate	-	-	-	-	-	-
	6,173	6,181	2,724	456	808	175
Total:	$28,050	$33,731	$2,724	$22,427	$30,354	$175

The increase in commercial loans with a related allowance recorded from December 31, 2011 to June 30, 2012 is primarily due to the impairment of two commercial relationships during the six months ended June 30, 2012.

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The following table summarizes the average recorded investments on impaired loans and the interest income recognized for the three months ended June 30, 2012 and June 30, 2011:

	For the three months ended					
	June 30, 2012			June 30, 2011		
	Average Recorded	Interest Income Recognized		Average Recorded	Interest Income Recognized	
(in thousands)	Investment	Accrual	Cash	Investment	Accrual	Cash
With no related allowance recorded:						
Commercial Loans						
Commercial	$1,128	$1	$1	$3,349	$26	$26
Commercial Real Estate	7,140	39	39	4,315	24	24
Agricultural	2,876	64	64	2,485	18	18
Agricultural Real Estate	1,876	5	5	1,720	21	21
Business Banking	6,572	41	41	7,930	89	89
Consumer Loans						
Home Equity	1,828	17	17	2,437	24	24
Residential Real Estate Mortgages	1,055	43	43	1,058	13	13
	$22,475	$210	$210	$23,294	$215	$215
With an allowance recorded:						
Commercial Loans						
Commercial	$5,010	$9	$9	$558	$19	$19
Commercial Real Estate	-	-	-	-	-	-
Agricultural	-	-	-	1,521	67	67
Agricultural Real Estate	-	-	-	706	13	13
	$5,010	$-	$-	$2,785	$99	$99
Total:	$27,485	$219	$219	$26,079	$314	$314

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The following table summarizes the average recorded investments on impaired loans and the interest income recognized for the six months ended June 30, 2012 and June 30, 2011:

	For the six months ended											
	June 30, 2012						June 30, 2011					
	Average Recorded		Interest Income Recognized				Average Recorded		Interest Income Recognized			
(in thousands)	Investment		Accrual		Cash		Investment		Accrual		Cash	
With no related allowance recorded:												
Commercial Loans												
Commercial	$	1,551	$	15	$	15	$	3,041	$	73	$	73
Commercial Real Estate		6,481		54		54		4,039		45		45
Agricultural		2,997		108		108		2,597		45		45
Agricultural Real Estate		1,926		10		10		1,496		38		38
Business Banking		7,151		97		97		4,666		102		102
Consumer Loans												
Home Equity		1,869		48		48		1,620		58		58
Residential Real Estate Mortgages		1,043		56		66		801		27		27
	$	23,018	$	388	$	388	$	18,260	$	388	$	388
With an allowance recorded:												
Commercial Loans												
Commercial	$	3,221	$	9	$	9	$	1,226	$	49	$	49
Commercial Real Estate		-		-		-		573		-		-
Agricultural		-		-		-		1,571		67		67
Agricultural Real Estate		-		-		-		713		18		18
	$	3,221	$	9	$	9	$	4,083	$	134	$	134
Total:	$	26,239	$	397	$	1,008	$	22,343	$	522	$	522

There has been significant disruption and volatility in the financial and capital markets since the second half of 2008. Turmoil in the mortgage industry adversely impacted both domestic and global economies and led to a significant credit and liquidity crisis in many domestic markets. These conditions were attributable to a variety of factors, in particular the fallout associated with subprime mortgage loans (a type of lending we have never actively pursued). The disruption was exacerbated by the decline of the real estate and housing market. However, in the markets in which the Company does business, the disruption has been somewhat delayed and less significant than in the national market. For example, our real estate market has not suffered the extreme declines seen nationally and our unemployment rate, while notably higher than in prior periods, is still below the national average.

While we continue to adhere to prudent underwriting standards, as a lender we may be adversely impacted by general economic weaknesses and, in particular, a sharp downturn in the housing market nationally. Decreases in real estate values could adversely affect the value of property used as collateral for our loans. Adverse changes in the economy

may have a negative effect on the ability of our borrowers to make timely loan payments, which would have an adverse impact on our earnings. An adverse impact on loan delinquencies would decrease our net interest income and adversely impact our loan loss experience, causing increases in our provision and allowance for loan losses.

The Company has developed an internal loan grading system to evaluate and quantify the Bank'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.

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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. All classified loans with outstanding balances of $500 thousand or more are evaluated individually for impairment through the quarterly review process. 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 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, 2012 and December 31, 2011:

Credit Quality Indicators
As of June 30, 2012

Commercial Credit Exposure By Internally Assigned Grade:	Commercial	Commercial Real Estate	Agricultural	Agricultural Real Estate	Total
Pass	$ 555,876	$ 950,168	$ 55,860	$ 29,348	$ 1,591,252
Special Mention	15,045	23,693	13	3	38,754
Substandard	22,752	43,269	7,534	4,662	78,217
Doubtful	2,978	-	58	-	3,036
Total	$ 596,651	$ 1,017,130	$ 63,465	$ 34,013	$ 1,711,259

Business Banking Credit Exposure By Internally Assigned Grade:	Business Banking	Total
Non-classified	$ 235,403	$ 235,403
Classified	17,005	17,005
Total	$ 252,408	$ 252,408

Consumer Credit Exposure By Payment Activity:	Indirect	Home Equity	Direct	Total
Performing	$ 921,720	$ 564,107	$ 69,483	$ 1,555,310
Nonperforming	2,055	9,063	328	11,446
Total	$ 923,775	$ 573,170	$ 69,811	$ 1,566,756

Residential Mortgage Credit Exposure By Payment Activity:	Residential Mortgage	Total
Performing	$ 621,812	$ 621,812
Nonperforming	8,979	8,979
Total	$ 630,791	$ 630,791

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Credit Quality Indicators
As of December 31, 2011

Commercial Credit Exposure By Internally Assigned Grade:	Commercial	Commercial Real Estate	Agricultural	Agricultural Real Estate	Total
Pass	$ 470,332	$ 758,673	$ 58,481	$ 28,927	$ 1,316,413
Special Mention	10,346	24,478	42	10	34,876
Substandard	29,940	51,748	7,945	4,989	94,622
Doubtful	456	-	69	-	525
Total	$ 511,074	$ 834,899	$ 66,537	$ 33,926	$ 1,446,436

Business Banking Credit Exposure By Internally Assigned Grade:	Business Banking	Total
Non-classified	$ 237,887	$ 237,887
Classified	18,254	18,254
Total	$ 256,141	$ 256,141

Consumer Credit Exposure By Payment Activity:	Indirect	Home Equity	Direct	Total
Performing	$ 870,270	$ 560,760	$ 72,849	$ 1,503,879
Nonperforming	2,833	8,885	518	