

CITY HOLDING CO  
Form 10-Q  
August 07, 2014  
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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-Q

(Mark One)

QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934  
For The Quarterly Period Ended June 30, 2014

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  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes  No

Indicate by check mark 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

Non-accelerated filer  Smaller reporting company

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

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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 – 15,501,470 shares as of August 6, 2014.

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## 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) 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; and (13) the effects of the Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") and the regulations promulgated and to be promulgated thereunder, which may subject the Company and its subsidiaries to a variety of new and more stringent legal and regulatory requirements which adversely affect their respective businesses. 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.

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City Holding Company and Subsidiaries

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## Part I - Financial Information

## Item 1 - Financial Statements

## Consolidated Balance Sheets

## City Holding Company and Subsidiaries

(in thousands)

	June 30, 2014	December 31, 2013
Assets	(Unaudited)	
Cash and due from banks	\$93,962	\$75,999
Interest-bearing deposits in depository institutions	16,778	9,877
Cash and Cash Equivalents	110,740	85,876
Investment securities available for sale, at fair value	258,761	352,660
Investment securities held-to-maturity, at amortized cost (approximate fair value at June 30, 2014 and December 31, 2013, - \$98,461 and \$5,335, respectively)	96,039	4,117
Other securities	14,234	13,343
Total Investment Securities	369,034	370,120
Gross loans	2,577,777	2,606,197
Allowance for loan losses	(20,536	) (20,575
Net Loans	2,557,241	2,585,622
Bank owned life insurance	93,567	92,047
Premises and equipment, net	80,171	82,548
Accrued interest receivable	7,727	6,866
Net deferred tax asset	37,793	42,165
Goodwill and other intangible assets	74,670	75,142
Other assets	33,771	27,852
Total Assets	\$3,364,714	\$3,368,238
Liabilities		
Deposits:		
Noninterest-bearing	\$500,391	\$493,228
Interest-bearing:		
Demand deposits	609,584	601,527
Savings deposits	635,293	612,772
Time deposits	1,040,979	1,077,606
Total Deposits	2,786,247	2,785,133
Short-term borrowings:		
Customer repurchase agreements	133,142	137,798
Long-term debt	16,495	16,495
Other liabilities	31,599	41,189
Total Liabilities	2,967,483	2,980,615
Shareholders' Equity	—	—

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

Common stock, par value \$2.50 per share: 50,000,000 shares authorized; 18,499,282 shares issued at June 30, 2014 and December 31, 2013, less 46,249 46,249  
2,892,542 and 2,748,922 shares in treasury, respectively

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Capital surplus	106,830	107,596	
Retained earnings	348,018	333,970	
Cost of common stock in treasury	(101,357	) (95,202	)
Accumulated other comprehensive income (loss):			
Unrealized gain (loss) on securities available-for-sale	371	(2,110	)
Underfunded pension liability	(2,880	) (2,880	)
Total Accumulated Other Comprehensive Loss	(2,509	) (4,990	)
Total Shareholders' Equity	397,231	387,623	
Total Liabilities and Shareholders' Equity	\$3,364,714	\$3,368,238	

See notes to consolidated financial statements.



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

	Three months ended June 30,		Six months ended June 30,	
	2014	2013	2014	2013
Interest Income				
Interest and fees on loans	\$28,621	\$31,771	\$58,355	\$61,709
Interest and dividends on investment securities:				
Taxable	2,930	2,632	5,933	5,382
Tax-exempt	277	312	558	636
Interest on federal funds sold	—	9	—	22
Total Interest Income	31,828	34,724	64,846	67,749
Interest Expense				
Interest on deposits	2,737	3,195	5,490	6,422
Interest on short-term borrowings	85	79	160	149
Interest on long-term debt	151	153	301	309
Total Interest Expense	2,973	3,427	5,951	6,880
Net Interest Income	28,855	31,297	58,895	60,869
Provision for loan losses	435	2,011	1,798	3,749
Net Interest Income After Provision for Loan Losses	28,420	29,286	57,097	57,120
Non-interest Income				
Gains on sale of investment securities	818	9	901	93
Service charges	6,739	6,897	12,899	13,432
Bankcard revenue	3,838	3,450	7,523	6,649
Insurance commissions	1,319	1,358	3,344	3,198
Trust and investment management fee income	1,111	964	2,148	1,954
Bank owned life insurance	765	799	1,521	1,611
Other income	549	775	1,108	1,641
Total Non-interest Income	15,139	14,252	29,444	28,578
Non-interest Expense				
Salaries and employee benefits	12,977	12,640	26,116	25,589
Occupancy and equipment	2,395	2,500	5,010	4,971
Depreciation	1,533	1,453	3,011	2,852
FDIC insurance expense	357	341	767	853
Advertising	925	819	1,749	1,554
Bankcard expenses	833	766	1,639	1,493
Postage, delivery, and statement mailings	530	552	1,105	1,158
Office supplies	420	463	830	904
Legal and professional fees	612	535	1,021	971
Telecommunications	506	465	844	910
Reposessed asset losses (gains), net of expenses	142	(23)	521	(178)
Merger related costs	—	65	—	5,604
Other expenses	3,075	3,383	5,068	6,682
Total Non-interest Expense	24,305	23,959	47,681	53,363
Income Before Income Taxes	19,254	19,579	38,860	32,335
Income tax expense	6,497	6,573	12,300	11,342



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Net Income Available to Common Shareholders	\$12,757	\$13,006	\$26,560	\$20,993
Total comprehensive income	\$14,462	\$8,798	\$29,041	\$16,875
Average common shares outstanding	15,556	15,582	15,583	15,521
Effect of dilutive securities:				
Employee stock awards and warrant outstanding	150	170	155	166
Shares for diluted earnings per share	15,706	15,752	15,738	15,687
Basic earnings per common share	\$0.81	\$0.83	\$1.69	\$1.34
Diluted earnings per common share	\$0.80	\$0.82	\$1.67	\$1.33
Dividends declared per common share	\$0.40	\$0.37	\$0.80	\$0.74

See notes to consolidated financial statements.

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

	Three Months Ended		Six Months Ended		
	June 30,		June 30,		
	2014	2013	2014	2013	
Net income	\$12,757	\$13,006	\$26,560	\$20,993	
Unrealized gains (losses) on available-for-sale securities arising during the period	3,521	(6,661	) 4,834	(6,434	)
Reclassification adjustment for gains	(818	) (9	) (901	) (93	)
Other comprehensive income (loss) before income taxes	2,703	(6,670	) 3,933	(6,527	)
Tax effect	(998	) 2,462	(1,452	) 2,409	
Other comprehensive income (loss), net of tax	1,705	(4,208	) 2,481	(4,118	)
Comprehensive income, net of tax	\$14,462	\$8,798	\$29,041	\$16,875	

See notes to consolidated financial statements.

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Consolidated Statements of Changes in Shareholders' Equity (Unaudited)  
City Holding Company and Subsidiaries  
Six Months Ended June 30, 2014 and 2013  
(in thousands)

	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			20,993			20,993
Other comprehensive loss					(4,118)	(4,118)
Acquisition of Community Financial Corporation		4,236		24,272		28,508
Cash dividends declared (\$0.74 per share)			(11,866)			(11,866)
Stock-based compensation expense, net		(512)		1,215		703
Exercise of 62,685 stock options		(13)		1,410		1,397
Balance at June 30, 2013	\$46,249	\$107,235	\$318,397	\$(97,450)	\$(5,540)	\$368,891
	Common Stock	Capital Surplus	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Income (Loss)	Total Shareholders' Equity
Balance at December 31, 2013	46,249	\$107,596	\$333,970	(95,202)	\$(4,990)	\$387,623
Net income			26,560			26,560
Other comprehensive income					2,481	2,481
Cash dividends declared (\$0.80 per share)			(12,512)			(12,512)
Stock-based compensation expense, net		(494)		1,383		889
Exercise of 19,000 stock options		(272)		825		553
Purchase of 194,651 treasury shares				(8,363)		(8,363)
Balance at June 30, 2014	46,249	\$106,830	\$348,018	(101,357)	\$(2,509)	\$397,231

See notes to consolidated financial statements.



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

	Six months ended June 30,	
	2014	2013
Net income	\$26,560	\$20,993
Adjustments to reconcile net income to net cash provided by operating activities:		
Accretion and amortization	(2,599	) (3,694
Provision for loan losses	1,798	3,749
Depreciation of premises and equipment	3,011	2,852
Deferred income tax expense	2,615	3,268
Net periodic employee benefit cost	286	378
Realized investment securities gains	(901	) (93
Stock-compensation expense	889	703
Increase in value of bank-owned life insurance	(1,520	) (1,608
Loans originated for sale	(2,454	) (15,656
Proceeds from the sale of loans originated for sale	3,129	19,576
Gain on sale of loans	(84	) (427
Change in accrued interest receivable	(861	) (189
Change in other assets	(5,986	) 15,945
Change in other liabilities	(9,919	) (11,469
Net Cash Provided by Operating Activities	13,964	34,328
Proceeds from sales of securities available-for-sale	1,660	18,438
Proceeds from maturities and calls of securities available-for-sale	26,237	60,543
Proceeds from maturities and calls of securities held-to-maturity	1,254	9,188
Purchases of securities available-for-sale	(13,530	) (22,335
Purchases of securities held-to-maturity	(10,226	) —
Net decrease (increase) in loans	29,225	(11,732
Purchases of premises and equipment	(664	) (3,276
Acquisition of Community Financial Corporation, net of cash acquired of \$8,888	—	(21,852
Net Cash Provided by Investing Activities	33,956	28,974
Net increase in noninterest-bearing deposits	7,163	37,908
Net (decrease) increase in interest-bearing deposits	(5,638	) 6,291
Net (decrease) increase in short-term borrowings	(4,656	) 9,697
Purchases of treasury stock	(8,363	) —
Proceeds from exercise of stock options, net of tax benefit	553	1,397
Dividends paid	(12,115	) (11,255
Net Cash (Used in) Provided by Financing Activities	(23,056	) 44,038
Increase in Cash and Cash Equivalents	24,864	107,340
Cash and cash equivalents at beginning of period	85,876	84,994
Cash and Cash Equivalents at End of Period	\$110,740	\$192,334

See notes to consolidated financial statements.

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Notes to Consolidated Financial Statements (Unaudited)

June 30, 2014

Note A –Background and Basis of Presentation

City Holding Company is a financial holding company headquartered in Charleston, West Virginia and conducts its principal activities through its wholly-owned subsidiary, City National Bank of West Virginia ("City National"). City National operates a network of 82 branch offices primarily along the I-64 corridor from Grayson, Kentucky through Lexington, Virginia; and along the I-81 corridor through the Shenandoah Valley from Staunton, Virginia to Martinsburg, West Virginia. City's branch network includes 57 offices in West Virginia, 14 offices in Virginia, 8 offices in Kentucky and 3 offices in Ohio. City National provides credit, deposit, investment advisory and insurance products and services to a broad geographical area that includes many rural and small community markets in addition to larger cities such as Charleston (WV), Huntington (WV), Winchester (VA), Staunton (VA), Virginia Beach (VA), Ashland (KY) and Martinsburg (WV). In addition to its branch network, the bank's delivery channels include ATMs, mobile banking, on-line banking, debit cards, cash management tools and telephone banking systems.

The accompanying consolidated financial statements, which are unaudited, include all of the accounts of the City Holding 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 six months ended June 30, 2014 are not necessarily indicative of the results of operations that can be expected for the year ending December 31, 2014. 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, 2013 has been derived from audited financial statements included in the Company's 2013 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 2013 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 2014, the FASB issued ASU No. 2014-01, "Investments - Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Qualified Affordable Housing Projects." This ASU permits reporting entities to make an accounting policy election to account for their investments in qualified affordable housing projects using the proportional amortization method if certain conditions are met. Under the proportional amortization method, an entity amortizes the initial cost of the investment in proportion to the tax credits and other tax benefits received and recognizes the net investment performance in the income statement as a component of income tax expense (benefit). For those investments in qualified affordable housing projects not accounted for using the proportional amortization method, the investment should be accounted for as an equity method investment or a cost method investment. The ASU also requires reporting entities to disclose information that enable users of its financial statements to understand the nature of its investments in qualified affordable housing projects, and the effect of the measurement of its investments in qualified affordable housing projects and the related tax credits on its financial position and results of



operations. This ASU will become effective for the Company on January 1, 2015. The adoption of ASU 2014-01 is not expected to have a material impact on the Company's financial statements.

In January 2014, the FASB issued ASU No. 2014-04, "Receivables - Troubled Debt Restructurings by Creditors (Subtopic 310-40): Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure." This ASU clarifies that an in substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (1) the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure or (2) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through similar legal agreement. Additionally, the amendments require interim and annual disclosures of both (1) the amount of foreclosed residential real estate property held by the creditor and (2) the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure according to local

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requirements of the applicable jurisdiction. This ASU will become effective for the Company on January 1, 2015. The adoption of ASU 2014-04 is not expected to have a material impact on the Company's financial statements.

In April 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No 2014-08, "Presentation of Financial Statements (Topic 205) and Property, Plant, and Equipment (Topic 360): Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity" This ASU changes the requirements for reporting discontinued operations. A disposal of a component or a group of components of an entity is required to be reported in discontinued operations if the disposal represents a strategic shift that has (or will have) a major effect on an entity's operations when certain criteria are met. Additional disclosures are also required for disposals that meet the criteria to be reported in discontinued operations. This ASU will become effective for the Company on January 1, 2015. The adoption of ASU 2014-08 is not expected to have a material impact on the Company's financial statements.

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No 2014-09, "Revenue from Contracts with Customers (Topic 606)". The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The core principle will be achieved using a five step process. This ASU will become effective for the Company on January 1, 2016. The adoption of ASU 2014-09 is not expected to have a material impact on the Company's financial statements.

In June 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No 2014-11, "Transfers and Servicing (Topic 860): Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures". The amendments in this update require two accounting changes. First, the amendments in this update change the accounting for repurchase-to-maturity transactions to secured borrowing accounting. Second, for repurchase financing arrangements, the amendments require separate accounting for a transfer of a financial asset executed contemporaneously with a repurchase agreement with the same counter-party, which will result in secured borrowing accounting for the repurchase agreement. This update also requires certain disclosures for these types of transactions. This ASU will become effective for the Company on January 1, 2015. The adoption of ASU 2014-11 is not expected to have a material impact on the Company's financial statements.

In June 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No 2014-12, "Compensation-Stock Compensation (Topic 718): Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period". The amendments in this update require that a performance target that affects vesting and that could be achieved after the requisite service period be treated as a performance condition. Performance targets should not be reflected in estimating the grant date fair value of the award, but compensation cost should be recognized in the period for which the requisite service has already been rendered. This ASU will become effective for the Company on January 1, 2016, with early adoption permitted. The adoption of ASU 2014-12 is not expected to have a material impact on the Company's financial statements.

Note C –Investments

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

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	June 30, 2014				December 31, 2013			
	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	\$2,049	\$29	\$—	\$2,078	\$2,317	\$48	\$—	\$2,365
Obligations of states and political subdivisions	39,276	883	19	40,140	41,027	627	106	41,548
Mortgage-backed securities:								
U.S. government agencies	192,241	3,361	3,072	192,530	282,653	2,765	7,310	278,108
Private label	1,946	15	—	1,961	2,184	16	3	2,197
Trust preferred securities	10,445	277	1,698	9,024	12,943	2,113	1,900	13,156
Corporate securities	7,797	230	357	7,670	9,788	183	843	9,128
Total Debt Securities	253,754	4,795	5,146	253,403	350,912	5,752	10,162	346,502
Marketable equity securities	2,537	1,309	—	3,846	3,334	1,339	—	4,673
Investment funds	1,525	—	13	1,512	1,525	—	40	1,485
Total Securities Available-for-Sale	\$257,816	\$6,104	\$5,159	\$258,761	\$355,771	\$7,091	\$10,202	\$352,660
	June 30, 2014				December 31, 2013			
	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								
Mortgage-backed securities								
US government agencies	\$91,916	\$1,841	\$—	\$93,757	\$—	\$—	\$—	\$—
Trust preferred securities	4,123	581	—	4,704	4,117	1,218	—	5,335
Total Securities Held-to-Maturity	\$96,039	\$2,422	\$—	\$98,461	\$4,117	\$1,218	\$—	\$5,335
Other investment securities:								
Non-marketable equity securities	\$14,234	\$—	\$—	\$14,234	\$13,343	\$—	\$—	\$13,343
Total Other Investment Securities	\$14,234	\$—	\$—	\$14,234	\$13,343	\$—	\$—	\$13,343

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):

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	June 30, 2014					
	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	\$1,549	\$1	\$468	\$18	\$2,017	\$19
Mortgage-backed securities:						
U.S. Government agencies	12,610	302	94,963	2,770	107,573	3,072
Trust preferred securities	477	201	4,809	1,497	5,286	1,698
Corporate securities	—	—	4,377	357	4,377	357
Investment funds	—	—	1,488	13	1,488	13
Total	\$14,636	\$504	\$106,105	\$4,655	\$120,741	\$5,159

	December 31, 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	\$5,600	\$87	\$243	\$19	\$5,843	\$106
Mortgage-backed securities:						
U.S. Government agencies	195,661	7,113	5,040	197	200,701	7,310
Private label	1,491	3	—	—	1,491	3
Trust preferred securities	—	—	4,400	1,900	4,400	1,900
Corporate securities	5,881	843	—	—	5,881	843
Investment funds	\$1,460	\$40	\$—	\$—	1,460	40
Total	\$210,093	\$8,086	\$9,683	\$2,116	\$219,776	\$10,202

Marketable equity securities consist of investments made by the Company in equity positions of various regional community bank holding companies, with ownership positions ranging from nominal to a 4% ownership position in First National Corporation (FXNC).

During the six months ended June 30, 2014 and 2013, the Company had no credit-related net investment impairment losses. Also, for the year ended December 31, 2013, the Company had no credit-related net investment impairment losses.

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 holding company stocks. Although the regional community bank holding company stocks that are owned by the Company are publicly traded, the trading activity for these stocks is minimal, with trading volumes of less than 0.2%

of each respective company being traded on a daily basis. 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.

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 June 30, 2014, 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 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 June 30, 2014, management believes the unrealized

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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 June 30, 2014, the book value of the Company's five pooled trust preferred securities totaled \$3.0 million with an estimated fair value of \$1.8 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 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 six months ended June 30, 2014 and for the year ended December 31, 2013 (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.



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	Debt Securities	Equity Securities	Total
Balance at January 1, 2013	\$21,186	\$4,813	\$25,999
Additions:			
Initial credit impairment	—	—	—
Additional credit impairment	—	—	—
Deductions:			
Sold	—	(115 )	(115 )
Balance at December 31, 2013	21,186	4,698	25,884
Additions:			
Initial credit impairment	—	—	—
Additional credit impairment	—	—	—
Deductions:			
Sold	—	(2,060 )	(2,060 )
Balance at June 30, 2014	\$21,186	\$2,638	\$23,824

The following table presents additional information about the Company's trust preferred securities with a credit rating of below investment grade as of June 30, 2014 (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 performing collateral)	Excess Subordination Percentage of Current Performing Collateral (4)
Pooled trust preferred securities:											
Other-than-temporarily impaired											
Available for Sale:											
P1	Pooled	Mezz	\$ 826	\$ 190	\$ 352	162	Caa1	7	19.5 %	20.0 % (2)	52.1 %
P2	Pooled	Mezz	2,535	—	—	—	Ca	6	22.3 %	— % (2)	— %
P3	Pooled	Mezz	2,962	1,419	671	(748 )	Caa3	22	24.1 %	8.2 % (2)	42.8 %
P4	Pooled	Mezz	4,060	400	151	(249 )	Ca	9	19.2 %	7.1 % (3)	26.9 %
P5	Pooled	Mezz	6,062	678	477	(201 )	Ca	9	22.7 %	20.0 % (2)	49.2 %
Held to Maturity:											
P6	Pooled	Mezz	1,599	123	704	581	Caa1	7	19.5 %	20.0 % (2)	52.1 %
P7	Pooled	Mezz	3,367	—	—	—	Ca	6	22.3 %	— % (2)	— %
Single issuer trust preferred securities											
Available for sale:											
S5	Single		261	235	336	101	NR	1	— %	— %	
Held to Maturity:											
S9	Single		4,000	4,000	4,000	—	NR	1	— %	— %	

(1)

The differences noted consist of unrealized gains (losses) recorded at June 30, 2014 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.

The amortized cost and estimated fair value of debt securities at June 30, 2014, by contractual maturity, are shown in the following table (in thousands). Expected maturities will differ from contractual maturities because the issuers of the securities

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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
<b>Securities Available-for-Sale</b>		
Due in one year or less	\$8,566	\$8,606
Due after one year through five years	17,995	18,533
Due after five years through ten years	30,416	31,321
Due after ten years	196,777	194,943
	\$253,754	\$253,403
<b>Securities Held-to-Maturity</b>		
Due in one year or less	\$—	\$—
Due after one year through five years	—	—
Due after five years through ten years	—	—
Due after ten years	96,039	98,461
	\$96,039	\$98,461

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		Six Months Ended	
	June 30, 2014	2013	June 30, 2014	2013
Gross realized gains	\$818	\$9	\$901	\$93
Gross realized losses	—	—	—	—
Net investment security gains	\$818	\$9	\$901	\$93

The carrying value of securities pledged to secure public deposits and for other purposes as required or permitted by law approximated \$264 million and \$278 million at June 30, 2014 and December 31, 2013, respectively.

## Statement of Cash Flows - Investing Activities - Supplemental Information

During the second quarter, the Company transferred certain securities from available-for-sale to held-to-maturity. The non-cash transfers of securities into the held-to-maturity categories from available-for-sale were made at fair value on the date of the transfer. The securities had an aggregate fair value of \$83.4 million, with an aggregate net unrealized loss of \$0.1 million on the date of transfer. The net unamortized, unrealized loss on the transferred securities included in accumulated other comprehensive income in the accompanying balance sheet as of June 30, 2014 totaled \$0.1 million. This amount will be amortized out of accumulated other comprehensive income over the remaining life of the underlying securities as an adjustment of the yield on those securities.

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## Note D –Loans

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

	June 30, 2014	December 31, 2013
Residential real estate	\$ 1,242,972	\$ 1,204,450
Home equity – junior liens	145,452	146,090
Commercial and industrial	149,442	164,484
Commercial real estate	993,552	1,040,866
Consumer	42,858	46,402
DDA overdrafts	3,501	3,905
Gross loans	2,577,777	2,606,197
Allowance for loan losses	(20,536	) (20,575
Net loans	\$ 2,557,241	\$ 2,585,622

Construction loans of \$20.1 million and \$17.3 million are included within residential real estate loans at June 30, 2014 and December 31, 2013, respectively. Construction loans of \$24.6 million and \$24.0 million are included within commercial real estate loans at June 30, 2014 and December 31, 2013, 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 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 following table details the loans acquired in conjunction with the Virginia Savings Bancorp, Inc. ("Virginia Savings") and Community Financial Corporation ("Community") acquisitions (in thousands):

	Virginia Savings	Community	Total
June 30, 2014			
Outstanding loan balance	\$43,261	\$245,314	\$288,575
Credit-impaired loans:			
Carrying value	3,098	17,902	21,000
Contractual principal and interest	3,735	27,394	31,129
December 31, 2013			
Outstanding loan balance	\$48,833	\$279,890	\$328,723
Credit-impaired loans:			
Carrying value	3,182	26,330	29,512
Contractual principal and interest	3,932	38,566	42,498



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Changes in the accretable yield of the credit-impaired loans for the six months ended June 30, 2014 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	\$698	\$3,182	\$10,389	\$26,330	\$11,087	\$29,512
Accretion	(127 )	127	(1,289 )	1,488	(1,416 )	1,615
Net reclassifications to accretable yield from						
non-accretable yield	149	—	3,205	—	3,354	—
Payments received, net	—	(211 )	—	(9,916 )	—	(10,127 )
Disposals	(2 )	—	(242 )	—	(244 )	—
Balance at the end of period	\$718	\$3,098	\$12,063	\$17,902	\$12,781	\$21,000

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 E – 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 of the allowance as it relates to these 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 table summarizes the activity in the allowance for loan loss, by portfolio segment, for the six months ended June 30, 2014 and 2013 (in thousands). The following table 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 June 30, 2014 and December 31, 2013 (in thousands).

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	Commercial & Industrial	Commercial Real Estate	Residential Real Estate	Home equity	Consumer	DDA Overdrafts	Total
Six months ended							
June 30, 2014							
Allowance for loan loss							
Beginning balance	\$1,139	\$10,775	\$6,057	\$1,672	\$77	\$855	\$20,575
Charge-offs	5	969	743	146	122	662	2,647
Recoveries	81	83	63	—	129	454	810
Provision	(248	)508	1,087	(83	)(3	)399	1,660
Provision for acquired loans	\$138	\$—	\$—	\$—	\$—	\$—	138
Ending balance	\$1,105	\$10,397	\$6,464	\$1,443	\$81	\$1,046	\$20,536
Six months ended							
June 30, 2013							
Allowance for loan loss							
Beginning balance	\$498	\$10,440	\$5,229	\$1,699	\$81	\$862	\$18,809
Charge-offs	392	622	1,111	270	224	687	3,306
Recoveries	21	34	68	—	217	477	817
Provision	939	642	1,792	222	7	147	3,749
Ending balance	\$1,066	\$10,494	\$5,978	\$1,651	\$81	\$799	\$20,069
As of June 30,							
2014							
Allowance for loan loss							
Evaluated for impairment:							
Individually	\$—	\$240	\$—	\$—	\$—	\$—	\$240
Collectively	1,063	9,500	6,428	1,443	81	1,046	19,561
Acquired with deteriorated credit quality							
	42	657	36	—	—	—	735
Total	\$1,105	\$10,397	\$6,464	\$1,443	\$81	\$1,046	\$20,536
Loans							
Evaluated for impairment:							
Individually	\$—	\$7,239	\$453	\$297	\$—	\$—	\$7,989
Collectively	147,711	970,095	1,242,007	142,736	42,738	3,501	2,548,788
Acquired with deteriorated credit quality							
	1,731	16,218	512	2,419	120	—	21,000
Total	\$149,442	\$993,552	\$1,242,972	\$145,452	\$42,858	\$3,501	\$2,577,777

As of December  
31, 2013

Allowance for  
loan loss

Evaluated for  
impairment:

Individually	\$—	\$880	\$—	\$—	\$—	\$—	\$880
Collectively	827	9,615	6,054	1,672	77	855	19,100
Acquired with deteriorated credit quality	312	280	3	—	—	—	595
Total	\$1,139	\$10,775	\$6,057	\$1,672	\$77	\$855	\$20,575

Loans

Evaluated for  
impairment:

Individually	\$—	\$11,837	\$459	\$298	\$—	\$—	\$12,594
Collectively	162,500	1,004,475	1,201,894	145,025	46,292	3,905	2,564,091
Acquired with deteriorated credit quality	1,984	24,554	2,097	767	110	—	29,512
Total	\$164,484	\$1,040,866	\$1,204,450	\$146,090	\$46,402	\$3,905	\$2,606,197

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## 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	Loans classified as special mention have a potential weakness(es) that deserves management's close attention. The potential weakness could result in deterioration of the loan repayment or the bank's credit position at some future date. A loan rated in this category poses a moderate loss risk to the bank.
Substandard	Loans classified as substandard reflect a customer with a well defined weakness that jeopardizes the liquidation of the debt. Loans in this category have the possibility that the bank will sustain some loss if the deficiencies are not corrected and the bank's collateral value is weakened by the financial deterioration of the borrower.
Doubtful	Loans classified as doubtful have all the weaknesses inherent in those classified as substandard, with the added characteristics that make collection of the full contract amount highly improbable. Loans rated in this category are most likely to cause the bank to have a loss due to a collateral shortfall or a negative capital position.



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The following table presents loans by the Company's commercial loans by credit quality indicators, by class (in thousands):

	Commercial and industrial	Commercial real estate	Total
June 30, 2014			
Pass	\$ 132,766	\$ 920,647	\$ 1,053,413
Special mention	10,643	19,771	30,414
Substandard	5,611	52,703	58,314
Doubtful	422	431	853
Total	\$ 149,442	\$ 993,552	\$ 1,142,994
December 31, 2013			
Pass	\$ 158,000	\$ 958,186	\$ 1,116,186
Special mention	648	20,072	20,720
Substandard	5,416	62,139	67,555
Doubtful	420	469	889
Total	\$ 164,484	\$ 1,040,866	\$ 1,205,350

The following table presents the Company's non-commercial loans by payment performance, by class (in thousands):

	Performing	Non-Performing	Total
June 30, 2014			
Residential real estate	\$ 1,239,717	\$ 3,255	\$ 1,242,972
Home equity - junior lien	145,217	235	145,452
Consumer	42,841	17	42,858
DDA overdrafts	3,501	—	3,501
Total	\$ 1,431,276	\$ 3,507	\$ 1,434,783
December 31, 2013			
Residential real estate	\$ 1,201,631	\$ 2,819	\$ 1,204,450
Home equity - junior lien	145,812	278	146,090
Consumer	46,353	49	46,402
DDA overdrafts	3,900	5	3,905
Total	\$ 1,397,696	\$ 3,151	\$ 1,400,847

## Aging Analysis of Accruing and Non-Accruing Loans

Interest income on loans is accrued and credited to operations based upon the principal amount outstanding, using methods that generally result in level rates of return. Loan origination fees, and certain direct costs, are deferred and amortized as an adjustment to the yield over the term of the loan. The accrual of interest generally is discontinued when a loan becomes 90 days past due as to principal or interest for all loan types. However, any loan may be placed on non-accrual if the Company receives information that indicates a borrower is unable to meet the contractual terms of their respective loan agreement. Other indicators considered for placing a loan on non-accrual status include the borrower's involvement in bankruptcies, foreclosures, repossessions, litigation and any other situation resulting in doubt as to whether full collection of contractual principal and interest is attainable. When interest accruals are discontinued, unpaid interest recognized in income in the current year is reversed, and interest accrued in prior years is charged to the allowance for loan losses. Management may elect to continue the accrual of interest when the net realizable value of collateral exceeds the principal balance and related accrued interest, and the loan is in the process of collection.

Generally for all loan classes, interest income during the period the loan is non-performing is recorded on a cash basis after recovery of principal is reasonably assured. Cash payments received on nonperforming loans are typically applied directly against the outstanding principal balance until the loan is fully repaid. Generally, loans are restored to accrual status when the obligation is brought current, has performed in accordance with the contractual terms for a reasonable period of time, and the ultimate collectability of the total contractual principal and interest is no longer in doubt.

Generally, all loan types are considered past due when the contractual terms of a loan are not met and the borrower is 30 days or more past due on a payment. Furthermore, residential and home equity loans are generally subject to charge-off

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when the loan becomes 120 days past due, depending on the estimated fair value of the collateral less cost to dispose, versus the outstanding loan balance. Commercial loans are generally charged off when the loan becomes 120 days past due. Open-end consumer loans are generally charged off when the loan becomes 180 days past due.

A loan acquired and accounted for under ASC Topic 310-30 is reported as an accruing loan and a performing asset provided that the loan is performing in accordance with the initial expectations. The loan would be considered non-performing if the loan's performance deteriorates below the initial expectations.

The following table presents an aging analysis of the Company's accruing and non-accruing loans, by class, as of June 30, 2014 and December 31, 2013 (in thousands):

Originated Loans							
June 30, 2014							
Accruing							
	Current	30-59 days	60-89 days	Over 90 days	Purchased-Credit Impaired	Non-accrual	Total
Residential real estate	\$1,140,373	\$4,421	\$789	\$584	\$ —	\$2,240	\$1,148,407
Home equity - junior lien	141,927	761	120	44	—	191	143,043
Commercial and industrial	133,028	—	25	—	—	137	133,190
Commercial real estate	817,777	443	—	—	—	9,087	827,307
Consumer	33,674	79	1	—	—	—	33,754
DDA overdrafts	3,220	276	5	—	—	—	3,501
Total	\$2,269,999	\$5,980	\$940	\$628	\$ —	\$11,655	\$2,289,202
Acquired Loans							
June 30, 2014							
Accruing							
	Current	30-59 days	60-89 days	Over 90 days	Purchased-Credit Impaired	Non-accrual	Total
Residential real estate	\$93,392	\$699	\$42	\$132	\$ —	\$300	\$94,565
Home equity - junior lien	2,406	3	—	—	—	—	2,409
Commercial and industrial	14,119	43	15	—	—	2,075	16,252
Commercial real estate	159,741	1,010	165	18	917	4,394	166,245
Consumer	8,730	330	27	17	—	—	9,104
DDA overdrafts	—	—	—	—	—	—	—
Total	\$278,388	\$2,085	\$249	\$167	\$917	\$6,769	\$288,575
Total Loans							
June 30, 2014							
Accruing							
	Current	30-59 days	60-89 days	Over 90 days	Purchased-Credit Impaired	Non-accrual	Total
Residential real estate	\$1,233,765	\$5,120	\$831	\$716	\$ —	\$2,540	\$1,242,972
Home equity - junior lien	144,333	764	120	44	—	191	145,452
Commercial and industrial	147,147	43	40	—	—	2,212	149,442
Commercial real estate	977,518	1,453	165	18	917	13,481	993,552

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Consumer	42,404	409	28	17	—	—	42,858
DDA overdrafts	3,220	276	5	—	—	—	3,501
Total	\$2,548,387	\$8,065	\$1,189	\$795	\$ 917	\$18,424	\$2,577,777

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Originated Loans  
December 31, 2013  
Accruing

	Current	30-59 days	60-89 days	Over 90 days	Purchased-Credit Impaired	Non-accrual	Total
Residential real estate	\$1,096,911	\$4,123	\$495	\$231	\$ —	\$1,905	\$1,103,665
Home equity - junior lien	141,967	880	—	42	—	236	143,125
Commercial and industrial	144,197	—	—	—	—	79	144,276
Commercial real estate	835,908	668	—	—	—	13,097	849,673
Consumer	32,647	172	7	4	—	—	32,830
DDA overdrafts	3,511	374	15	5	—	—	3,905
Total	\$2,255,141	\$6,217	\$517	\$282	\$ —	\$15,317	\$2,277,474

Acquired Loans  
December 31, 2013  
Accruing

	Current	30-59 days	60-89 days	Over 90 days	Purchased-Credit Impaired	Non-accrual	Total
Residential real estate	\$99,089	\$842	\$172	\$—	\$ —	\$682	\$100,785
Home equity - junior lien	2,965	—	—	—	—	—	2,965
Commercial and industrial	18,253	—	80	—	—	1,875	20,208
Commercial real estate	176,018	2,772	273	109	7,534	4,487	191,193
Consumer	12,876	622	29	45	—	—	13,572
DDA overdrafts	—	—	—	—	—	—	—
Total	\$309,201	\$4,236	\$554	\$154	\$ 7,534	\$7,044	\$328,723

Total Loans  
December 31, 2013  
Accruing

	Current	30-59 days	60-89 days	Over 90 days	Purchased-Credit Impaired	Non-accrual	Total
Residential real estate	\$1,196,000	\$4,965	\$667	\$231	\$ —	\$2,587	\$1,204,450
Home equity - junior lien	144,932	880	—	42	—	236	146,090
Commercial and industrial	162,450	—	80	—	—	1,954	164,484
Commercial real estate	1,011,926	3,440	273	109	7,534	17,584	1,040,866
Consumer	45,523	794	36	49	—	—	46,402
DDA overdrafts	3,511	374	15	5	—	—	3,905
Total	\$2,564,342	\$10,453	\$1,071	\$436	\$ 7,534	\$22,361	\$2,606,197





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The following table presents the Company's impaired loans, by class, as of June 30, 2014 and December 31, 2013 (in thousands). The difference between the unpaid principal balance and the recorded investment generally reflects amounts that have been previously charged-off.

	June 30, 2014			December 31, 2013		
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Recorded Investment	Unpaid Principal Balance	Related Allowance
With no related allowance recorded:						
Residential real estate	\$453	\$453	\$—	\$459	\$459	\$—
Home equity - junior liens	297	297	—	298	298	—
Commercial and industrial	—	—	—	—	—	—
Commercial real estate	5,837	6,629	—	8,421	8,361	—
Consumer	—	—	—	—	—	—
DDA overdrafts	—	—	—	—	—	—
Total	\$6,587	\$7,379	\$—	\$9,178	\$9,118	\$—
With an allowance recorded						
Residential real estate	\$—	\$—	\$—	\$—	\$—	\$—
Home equity - junior liens	—	—	—	—	—	—
Commercial and industrial	—	—	—	—	—	—
Commercial real estate	1,403	4,333	240	3,416	3,416	880
Consumer	—	—	—	—	—	—
DDA overdrafts	—	—	—	—	—	—
Total	\$1,403	\$4,333	\$240	\$3,416	\$3,416	\$880

The following table presents information related to the average recorded investment and interest income recognized on the Company's impaired loans, by class (in thousands):

	For the six months ended			
	June 30, 2014		June 30, 2013	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:				
Residential real estate	\$455	\$—	\$464	\$—
Home equity - junior liens	297	—	297	—
Commercial and industrial	—	—	—	—
Commercial real estate	8,120	9	9,450	—
Consumer	—	—	—	—
DDA overdrafts	—	—	—	—
Total	\$8,872	\$9	\$10,211	\$—
With an allowance recorded				
Residential real estate	\$—	\$—	\$—	\$—
Home equity - junior liens	—	—	—	—
Commercial and industrial	—	—	—	—
Commercial real estate	2,055	68	3,103	—
Consumer	—	—	—	—

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DDA overdrafts	—	—	—	—
Total	\$2,055	\$68	\$3,103	\$—

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Approximately \$0.2 million and \$0.3 million of interest income would have been recognized during the six months ended June 30, 2014 and 2013, if such loans had been current in accordance with their original terms. There were no commitments to provide additional funds on non-accrual, impaired or other potential problem loans at June 30, 2014.

## Loan Modifications

The Company's policy on loan modifications typically does not allow for modifications that would be considered a concession from the Company. However, when there is a modification, the Company evaluates each modification to determine if the modification constitutes a troubled debt restructuring ("TDR") in accordance with ASU 2011-2, whereby a modification of a loan would be considered a TDR when both of the following conditions are met: (1) a borrower is experiencing financial difficulty and (2) the modification constitutes a concession. When determining whether the borrower is experiencing financial difficulties, the Company reviews whether the debtor is currently in payment default on any of its debt or whether it is probable that the debtor would be in payment default in the foreseeable future without the modification. Other indicators of financial difficulty include whether the debtor has declared or is in the process of declaring bankruptcy, the debtor's ability to continue as a going concern, or the debtor's projected cash flow to service its debt (including principal and interest) in accordance with the contractual terms for the foreseeable future, without a modification.

Regulatory guidance requires loans to be accounted for as collateral-dependent loans when borrowers have filed Chapter 7 bankruptcy, the debt has been discharged by the bankruptcy court and the borrower has not reaffirmed the debt. The filing of bankruptcy is deemed to be evidence that the borrower is in financial difficulty and the discharge of the debt by the bankruptcy court is deemed to be a concession granted to the borrower.

The following tables set forth the Company's TDRs (in thousands):

	June 30, 2014			December 31, 2013		
	Accruing	Non-Accruing	Total	Accruing	Non-Accruing	Total
Commercial and industrial	\$86	\$—	\$86	\$88	\$—	\$88
Commercial real estate	2,281	—	2,281	1,783	—	1,783
Residential real estate	18,893	320	19,213	18,651	1,693	20,344
Home equity	2,803	55	2,858	2,859	14	2,873
Consumer	—	—	—	—	—	—
	\$24,063	\$375	\$24,438	\$23,381	\$1,707	\$25,088
	New TDRs For the six months ended June 30, 2014			New TDRs For the six months ended June 30, 2013		
	Number of Contracts	Pre Modification Outstanding Recorded Investment	Post Modification Outstanding Recorded Investment	Number of Contracts	Pre Modification Outstanding Recorded Investment	Post Modification Outstanding Recorded Investment
Commercial and industrial	1	\$5	\$5	1	\$95	\$95
Commercial real estate	1	434	434	3	1,571	1,571
Residential real estate	16	1,209	1,209	26	2,845	2,845
Home equity	7	170	170	8	185	185
Consumer	—	—	—	—	—	—
	25	\$1,818	\$1,818	38	\$4,696	\$4,696



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## Note F – Long-Term Debt

The components of long-term debt are summarized below (in thousands):

	June 30, 2014	December 31, 2013
Junior subordinated debentures owed to City Holding Capital Trust III, due 2038, interest at a rate of 3.73% and 3.74%, respectively	\$ 16,495	\$ 16,495

The Company formed a statutory business trust, City Holding Capital Trust III (“Capital Trust III”), under the laws of Delaware. Capital Trust III was created for the exclusive purpose of (i) issuing trust-preferred capital securities (“Capital Securities”), which represent preferred undivided beneficial interests in the assets of the trust, (ii) using the proceeds from the sale of the Capital Securities to acquire junior subordinated debentures (“Debentures”) issued by the Company, and (iii) engaging in only those activities necessary or incidental thereto. The trust is considered a variable interest entity for which the Company is not the primary beneficiary. Accordingly, the accounts of the trusts are not included in the Company’s consolidated financial statements.

Distributions on the Debentures are cumulative and will be payable quarterly at an interest rate of 3.50% over the three month LIBOR rate, reset quarterly. Interest payments are due in March, June, September and December. The Debentures are redeemable prior to maturity at the option of the Company (i) in whole or at any time or in part from time-to-time, or (ii) in whole, but not in part, at any time within 90 days following the occurrence and during the continuation of certain pre-defined events.

Payments of distributions on the trust preferred securities and payments on redemption of the trust preferred securities are guaranteed by the Company. The Company also entered into an agreement as to expenses and liabilities with the trust pursuant to which it agreed, on a subordinated basis, to pay any cost, expenses or liabilities of the trust other than those arising under the trust preferred securities. The obligations of the Company under the junior subordinated debentures, the related indentures, the trust agreement establishing the trust, the guarantees and the agreements as to expenses and liabilities, in the aggregate, constitute a full and unconditional guarantee by the Company of the trust’s obligations under the trust preferred securities. The Capital Securities issued by the statutory business trusts qualify as Tier 1 capital for the Company under current Federal Reserve Board guidelines.

## Note G – Derivative Instruments

As of June 30, 2014 and December 31, 2013, the Company has derivative financial instruments not included in hedge relationships. These derivatives consist of interest rate swaps used for interest rate management purposes and derivatives executed with commercial banking customers to facilitate their interest rate management strategies.

The following table summarizes the fair value of these derivative instruments (in thousands):

Fair Value:	June 30, 2014	December 31, 2013
Other Assets	\$ 8,383	\$ 3,538
Other Liabilities	8,383	3,538

The following table summarizes the change in fair value of these derivative instruments (in thousands):

Change in Fair Value:	Three months ended June 30,		Six months ended June 30,	
	2014	2013	2014	2013
Other income - derivative asset	\$ 2,552	\$ (6,211	) \$ 4,606	\$ (7,790

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Other income - derivative liability (2,552 ) 6,211 (4,606 ) 7,790

Certain financial instruments, including derivatives, may be eligible for offset in the consolidated balance sheet and/or subject to master netting arrangements. The Company's derivative transactions with financial institution counterparties are generally executed under International Swaps and Derivative Association ("ISDA") master agreements which include "right of setoff" provisions. In such cases there is generally a legally enforceable right to offset recognized amounts and there may be an intention to settle such amounts on a net basis. Nonetheless, the Company does not generally offset financial instruments for financial reporting purposes. Information about financial instruments that are eligible for offset in the consolidated balance sheet as of June 30, 2014 is presented in the following tables (in thousands):

Description	Gross Amounts of Recognized Assets (a)	Gross Amounts Offset in the Statement of Financial Position (b)	Net Amounts of Assets presented in the Statement of Financial Position (c)=(a)-(b)	Gross Amounts Not Offset in the Statement of Financial Position		Total of Gross Amounts Not Offset in the Statement of Financial Position Including Applicable Netting Agreement and Fair Value of Collateral (d)	Net Amount (c)-(d)
				Netting Adjustment per Applicable Master Netting Arrangements	Fair Value of Financial Collateral		
Derivative assets:							
Interest rate swap agreements	\$8,383	\$—	\$8,383	\$—	\$8,383	\$8,383	\$—

Description	Gross Amounts of Recognized Liabilities (a)	Gross Amounts Offset in the Statement of Financial Position (b)	Net Amounts of Liabilities presented in the Statement of Financial Position (c)=(a)-(b)	Gross Amounts Not Offset in the Statement of Financial Position		Total of Gross Amounts Not Offset in the Statement of Financial Position Including Applicable Netting Agreement and Fair Value of Collateral (d)	Net Amount (c)-(d)
				Netting Adjustment per Applicable Master Netting Arrangements	Fair Value of Financial Collateral		

Derivative liabilities:

Interest rate swap agreements	\$8,383	\$—	\$8,383	\$—	\$11,720	\$11,720	\$—
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## Note H – Employee Benefit Plans

Pursuant to the terms of the City Holding Company 2003 Incentive Plan and the City Holding Company 2013 Incentive Plan (the "2003 Plan" and "2013 Plan", respectively), the Compensation Committee of the Board of Directors, or its delegate, may, from time-to-time, grant stock options, stock appreciation rights ("SARs"), or stock awards to employees, directors and individuals who provide service to the Company (collectively, "Plan Participants"). The 2003 Plan expired in April of 2013 and the 2013 Plan was approved by the shareholders in April 2013. A maximum of 750,000 shares of the Company's common stock may be issued upon the exercise of stock options, SARs and stock awards. These limitations may be adjusted in the event of a change in the number of outstanding shares of common stock by reason of a stock dividend, stock split or other similar event. Specific terms of options and SARs awarded, including vesting periods, exercise prices (stock price at date of grant) and expiration dates are determined at the date of grant and are evidenced by agreements between the Company and the awardee. The exercise price of the option grants equals the market price of the Company's stock on the date of grant. All incentive stock options and SARs will be exercisable up to 10 years from the date granted and all options and SARs are exercisable for the period specified in the individual agreement. As of June 30, 2014, under the 2003 Plan and 2013 Plan, 411,601 stock options had been awarded and 228,009 restricted stock awards had been awarded, respectively.

Each award from the Plan is evidenced by an award agreement that specifies the option price, the duration of the option, the number of shares to which the option pertains, and such other provisions as the Compensation Committee, or its delegate, determines. The option price for each grant is equal to the fair market value of a share of the Company's common stock on the date of the grant. Options granted expire at such time as the Compensation Committee, or its delegate, determines at the date of the grant and in no event does the exercise period exceed a maximum of ten years. Upon a change-in-control of the Company, as defined in the Plan, all outstanding options and awards shall immediately vest.

## Stock Options

A summary of the Company's stock option activity and related information is presented below:

	Six months ended June 30,			
	2014		2013	
	Options	Weighted-Average Exercise Price	Options	Weighted-Average Exercise Price
Outstanding at January 1	173,601	\$ 35.26	289,544	\$ 34.38
Granted	13,953	44.43	15,475	37.74
Exercised	(19,000)	29.13	(62,685)	32.89
Forfeited	—	—	(1,500)	36.90
Outstanding at June 30	168,554	\$ 36.71	240,834	\$ 34.96

Additional information regarding stock options outstanding and exercisable at June 30, 2014, is provided in the following table:

Ranges of Exercise Prices	No. of Options Outstanding	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Life (Years)	Aggregate Intrinsic Value (in thousands)	No. of Options Currently Exercisable	Weighted-Average Exercise Price of Currently Exercisable	Weighted-Average Remaining Contractual Life (Years)	Aggregate Intrinsic Value of Options Currently Exercisable (in thousands)



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\$26.62 - \$33.90	40,250	\$ 30.83	4.1	\$575	19,332	\$ 30.46	2.7	\$ 283
\$35.09 - \$44.43	128,304	38.55	5.3	843	66,000	39.15	2.6	394
	168,554			\$1,418	85,332			\$ 677

Proceeds from stock option exercises were \$0.6 million and \$1.4 million during the six months ended June 30, 2014 and 2013, respectively. Shares issued in connection with stock option exercises are issued from available treasury shares. If no treasury shares are available, new shares are issued from available authorized shares. During the six months ended June 30, 2014 and 2013 all shares issued in connection with stock option exercises and restricted stock awards were issued from available treasury stock.

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The total intrinsic value of stock options exercised was \$0.3 million and \$0.2 million during the six months ended June 30, 2014 and 2013, respectively.

Stock-based compensation expense was approximately \$0.1 million for the both the six months ended June 30, 2014 and 2013. Unrecognized stock-based compensation expense related to stock options approximated \$0.5 million at June 30, 2014. At such date, the weighted-average period over which this unrecognized expense was expected to be recognized was 1.6 years.

The fair value of the options is estimated at the date of grant using a Black-Scholes option-pricing model. The following weighted average assumptions were used to estimate the fair value of options granted:

	Six months ended June 30,			
	2014		2013	
Risk-free interest rate	2.42	%	1.88	%
Expected dividend yield	3.60	%	3.70	%
Volatility factor	48.75	%	41.35	%
Expected life of option	8.0 years		8.0 years	

## Restricted Shares

The Company records compensation expense with respect to restricted shares in an amount equal to the fair value of the common stock covered by each award on the date of grant. The restricted shares awarded become fully vested after various periods of continued employment from the respective dates of grant. The Company is entitled to an income tax deduction in an amount equal to the taxable income reported by the holders of the restricted shares when the restrictions are released and the shares are issued. Compensation is being charged to expense over the respective vesting periods.

Restricted shares are forfeited if officers and employees terminate prior to the lapsing of restrictions. The Company records forfeitures of restricted stock as treasury share repurchases and any compensation cost previously recognized is reversed in the period of forfeiture. Recipients of restricted shares do not pay any cash consideration to the Company for the shares, have the right to vote all shares subject to such grant and receive all dividends with respect to such shares, whether or not the shares have vested. Stock-based compensation expense related to restricted shares was approximately \$0.5 million and \$0.3 million for the six months ended June 30, 2014 and 2013, respectively. Unrecognized stock-based compensation expense related to non-vested restricted shares was \$3.3 million at June 30, 2014. At June 30, 2014, this unrecognized expense is expected to be recognized over 3.7 years based on the weighted average-life of the restricted shares.

A summary of the Company's restricted shares activity and related information is presented below:

	Six months ended June 30,			
	2014		2013	
	Restricted Awards	Average Market Price at Grant	Restricted Awards	Average Market Price at Grant
Outstanding at January 1	142,469		116,711	
Granted	25,062	\$43.05	32,083	\$37.57
Forfeited/Vested	(6,200)	)	(8,075)	)
Outstanding at June 30	161,331		140,719	

## Benefit Plans

The Company provides retirement benefits to its employees through the City Holding Company 401(k) Plan and Trust (“the 401(k) Plan”), which is intended to be compliant with Employee Retirement Income Security Act (ERISA) section 404(c). The Company’s total expense associated with the retirement benefit plan approximated \$0.4 million for both the six months ended June 30, 2014 and 2013.

The Company maintains two frozen defined benefit pension plans (“the Defined Benefit Plans”), which were inherited from the Company's acquisition of the plan sponsors (Horizon Bancorp, Inc. and Community Financial Corporation). The Company made contributions of approximately \$0.2 million to the Defined Benefit Plans during the six months ended June 30, 2014 and 2013.

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The following table presents the components of the net periodic pension cost of the Defined Benefit Plans (in thousands):

	Three months ended June 30,		Six months ended June 30,	
	2014	2013	2014	2013
Components of net periodic cost:				
Interest cost	\$209	\$186	\$425	\$332
Expected return on plan assets	(252	) (233	) (527	) (419
Net amortization and deferral	150	245	388	465
Net Periodic Pension Cost	\$107	\$198	\$286	\$378

## Note I – Commitments and Contingencies

The Company is a party to certain financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. The Company has entered into agreements with its customers to extend credit or provide a conditional commitment to provide payment on drafts presented in accordance with the terms of the underlying credit documents. The Company also provides overdraft protection to certain demand deposit customers that represent an unfunded commitment. Overdraft protection commitments, which are included with other commitments below, are uncollateralized and are paid at the Company's discretion. Conditional commitments generally include standby and commercial letters of credit. Standby letters of credit represent an obligation of the Company to a designated third party contingent upon the failure of a customer of the Company to perform under the terms of the underlying contract between the customer and the third party. Commercial letters of credit are issued specifically to facilitate trade or commerce. Under the terms of a commercial letter of credit, drafts will be drawn when the underlying transaction is consummated, as intended, between the customer and a third party. The funded portion of these financial instruments is reflected in the Company's balance sheet, while the unfunded portion of these commitments is not reflected in the balance sheet. The table below presents a summary of the contractual obligations of the Company resulting from significant commitments (in thousands):

	June 30, 2014	December 31, 2013
Commitments to extend credit:		
Home equity lines	\$175,284	\$174,417
Commercial real estate	31,653	42,209
Other commitments	163,960	201,065
Standby letters of credit	14,199	14,122
Commercial letters of credit	1,661	1,555

Loan commitments and standby and commercial letters of credit have credit risks essentially the same as that involved in extending loans to customers and are subject to the Company's standard credit policies. Collateral is obtained based on management's credit assessment of the customer. Management does not anticipate any material losses as a result of these commitments.

The Company is engaged in various legal actions that it deems to be in the ordinary course of business. As these legal actions are resolved, the Company could realize positive and/or negative impact to its financial performance in the period in which these legal actions are ultimately decided. There can be no assurance that current actions will have immaterial results, either positive or negative, or that no material actions may be presented in the future.



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## Note J – Accumulated Other Comprehensive Loss

The activity in accumulated other comprehensive loss for the six months ended June 30, 2014 and 2013 is presented in the tables below (in thousands). All amounts are shown net of tax, which is calculated using a combined Federal and state income tax rate approximating 37%.

	Accumulated Other Comprehensive Loss		
	Defined Benefit Pension Plans	Unrealized Gains (Losses) on Securities Available-for-Sale	Total
Balance at December 31, 2012	\$(4,995	) \$3,573	\$(1,422 )
Other comprehensive income before reclassifications	—	(4,059	) (4,059 )
Amounts reclassified from other comprehensive loss	—	(59	) (59 )
	—	(4,118	) (4,118 )
Balance at June 30, 2013	\$(4,995	) \$(545	) \$(5,540 )
Balance at December 31, 2013	\$(2,880	) \$(2,110	) \$(4,990 )
Other comprehensive income before reclassifications	—	3,050	3,050
Amounts reclassified from other comprehensive loss	—	(569	) (569 )
	—	2,481	2,481
Balance at June 30, 2014	\$(2,880	) \$371	\$(2,509 )

	Amount reclassified from Other Comprehensive Loss				Affected line item in the Statements of Income
	Three months ended June 30,		Six months ended June 30,		
	2014	2013	2014	2013	
Securities available-for-sale:					
Net securities gains reclassified into earnings	\$ (818	) \$ (9	) \$ (901	) \$ (93	) Security gains (losses)
Related income tax expense	301	3	332	34	Income tax expense
Net effect on accumulated other comprehensive loss	\$(517	) \$ (6	) \$ (569	) \$ (59	)

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## Note K – Earnings per Share

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

	Three months ended June 30,		Six months ended June 30,	
	2014	2013	2014	2013
Distributed earnings allocated to common stock	\$6,178	\$5,751	\$12,356	\$11,502
Undistributed earnings allocated to common stock	6,448	7,139	13,931	9,303
Net earnings allocated to common shareholders	\$12,626	\$12,890	\$26,287	\$20,805
Average shares outstanding	15,556	15,582	15,583	15,521
Effect of dilutive securities:				
Warrant outstanding	62	62	62	59
Employee stock awards	88	108	93	107
Shares for diluted earnings per share	15,706	15,752	15,738	15,687
Basic earnings per share	\$0.81	\$0.83	\$1.69	\$1.34
Diluted earnings per share	\$0.80	\$0.82	\$1.67	\$1.33

Options to purchase approximately 57,500 shares of common stock at an exercise price between \$39.34 and \$40.88 per share were outstanding during the second quarter of 2013 but were not included in the computation of diluted earnings per share because the options' exercise price was greater than the average market price of the common shares and therefore, the effect would have been anti-dilutive. During the second quarter of 2014, there were no anti-dilutive options outstanding.

## Note L – Fair Value Measurements

Fair value of an asset or liability is the price that would be received to sell that asset or paid to transfer that liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. ASC Topic 820 establishes a fair value hierarchy for valuation inputs that gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. The fair value hierarchy is as follows:

Level 1: Quoted prices (unadjusted) or identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

Level 2: Significant other observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities, quoted prices in markets that are not active, and other inputs that are observable or can be corroborated by observable market data.

Level 3: Significant unobservable inputs that reflect a company's own assumptions about the assumptions that market participants would use in pricing an asset or liability.

The Company bases fair value of assets and liabilities on quoted market prices, prices for similar assets or liabilities, quoted prices in markets that are not active, and other inputs that are observable or can be corroborated by observable market data. If such information is not available, fair value is based upon internally developed models that primarily use, as inputs, observable market-based parameters. Valuation adjustments may be made to ensure that financial instruments are recorded at fair value. These adjustments may include amounts to reflect counterparty credit quality

and the Company's creditworthiness, among other things, as well as unobservable parameters. Any such valuation adjustments are applied consistently over time. The Company's valuation methodologies may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. While management believes the company's valuation methodologies are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine fair value of certain financial instruments could result in a different estimate of fair value at the reporting date. Furthermore, the reported fair value amounts have not been comprehensively revalued since the presentation dates, and therefore, estimates of fair value after the balance sheet date may differ significantly from the amount presented herein. A more detailed description of the valuation methodologies used for assets and liabilities measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy, is set forth below.



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Financial Assets and Liabilities

The Company used the following methods and significant assumptions to estimate fair value for financial assets and liabilities measured on a recurring basis.

**Securities Available for Sale.** Securities available for sale are reported at fair value utilizing Level 1, Level 2, and Level 3 inputs. The fair value of securities available for sale is determined by utilizing a market approach by obtaining quoted prices on nationally recognized securities exchanges (other than forced or distressed transactions) that occur in sufficient volume or matrix pricing, which is a mathematical technique used widely in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities. If such measurements are unavailable, the security is classified as Level 3. Significant judgment is required to make this determination.

The Company utilizes a third party pricing service provider to value its Level 1 and Level 2 investment securities. Annually, the Company obtains an independent auditor's report from its third party pricing service provider regarding its controls over investment securities. Although no control deficiencies were noted, the report did contain caveats and disclaimers regarding the pricing information, such as the Company should review fair values for reasonableness. On a quarterly basis, the Company selects a sample of its debt securities and reprices those securities with a third party that is independent of the primary pricing service provider to verify the reasonableness of the fair values. In addition, the Company selects a sample of securities and reviews the underlying support from the primary pricing service provider.

The Company has determined that its pooled trust preferred securities should be priced using Level 3 inputs in accordance with ASC Topic 820 and guidance issued by the SEC. The Company has determined that there are few observable transactions and market quotations available for pooled trust preferred securities and they are not reliable for purposes of determining fair value at June 30, 2014. Due to these circumstances, the Company has elected to utilize an income valuation approach produced by a third party pricing source. This third party model utilizes deferral and default probabilities for the underlying issuers, estimated prepayment rates and assumes no future recoveries of any defaults or deferrals. The Company then compares the values provided by the third party model with other external sources. At such time as there are observable transactions or quoted prices that are associated with an orderly and active market for pooled trust preferred securities, the Company will incorporate such market values in its estimate of fair values for these securities.

**Derivatives.** Derivatives are reported at fair value utilizing Level 2 inputs. The Company utilizes a market approach by obtaining dealer quotations to value its customer interest rate swaps. The Company's derivatives are included within its Other Assets and Other Liabilities in the accompanying consolidated balance sheets. Derivative assets are typically secured through securities with financial counterparties or cross collateralization with a borrowing customer. Derivative liabilities are typically secured through the Company pledging securities to financial counterparties or, in the case of a borrowing customer, by the right of setoff. The Company considers such factors such as the likelihood of default by itself and its counterparties, right of setoff, and remaining maturities in determining the appropriate fair value adjustments. All derivative counterparties approved by the Company's Asset and Liability Committee ("ALCO") are regularly reviewed, and appropriate business action is taken to adjust the exposure to certain counterparties, if necessary. Counterparty exposure is evaluated by netting positions that are subject to master netting agreements, as well as considering the amount of marketable collateral securing the position. This approach used to estimate impacted exposures to counterparties is also used by the Company to estimate its own credit risk in derivative liability positions. To date, no material losses have been incurred due to a counterparty's inability to pay any undercollateralized position. There was no significant change in the value of derivative assets and liabilities attributed to credit risk during the three and six months ended June 30, 2014.

The Company may be required, from time to time, to measure certain financial assets and financial liabilities at fair value on a nonrecurring basis. Financial assets measured at fair value on a nonrecurring basis include impaired loans reported at the fair value of the underlying collateral if repayment is expected solely from the collateral. Collateral values are estimated using Level 2 inputs based on observable market data for real estate collateral or Level 3 inputs for non-real estate collateral. The following table presents assets and liabilities measured at fair value (in thousands):

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	Total	Level 1	Level 2	Level 3	Total Gains (Losses)
June 30, 2014					
Recurring fair value measurements					
Financial Assets					
U.S. Government agencies	\$2,078	\$—	\$2,078	\$—	
Obligations of states and political subdivisions	40,140	—	40,140	—	
Mortgage-backed securities:					
U.S. Government agencies	192,530	—	192,530	—	
Private label	1,961	—	1,961	—	
Trust preferred securities	9,024	—	7,037	1,987	
Corporate securities	7,670	—	7,670	—	
Marketable equity securities	3,846	3,846	—	—	
Investment funds	1,512	1,512	—	—	
Derivative assets	8,383	—	8,383	—	
Financial Liabilities					
Derivative liabilities	8,383	—	8,383	—	
Nonrecurring fair value measurements					
Impaired loans	\$7,750	\$—	\$—	\$7,750	\$(130 )
Other real estate owned	9,128	—	—	9,128	(374 )
December 31, 2013					
Recurring fair value measurements					
Financial Assets					
U.S. Government agencies	\$2,365	\$—	\$2,365	\$—	
Obligations of states and political subdivisions	41,548	—	41,548	—	
Mortgage-backed securities:					
U.S. Government agencies	278,108	—	278,108	—	
Private label	2,197	—	2,197	—	
Trust preferred securities	13,156	—	9,269	3,887	
Corporate securities	9,128	—	9,128	—	
Marketable equity securities	4,673	4,673	—	—	
Investment funds	1,485	1,485	—	—	
Derivative assets	3,538	—	3,538	—	
Financial Liabilities					
Derivative liabilities	3,538	—	3,538	—	
Nonrecurring fair value measurements					
Impaired loans	\$11,714	\$—	\$—	\$11,714	\$(880 )
Other real estate owned	\$8,470	\$—	\$—	\$8,470	\$(1,108 )

The table below presents a reconciliation of the Company's financial assets and liabilities measured at fair value on a recurring basis using significant unobservable inputs (Level 3) (in thousands):

Six months ended June 30,  
2014                      2013

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Beginning balance	\$3,887	\$2,385	
Impairment losses on investment securities	—	—	
Included in other comprehensive income	(1,900	) 1,840	
Dispositions	—	(1,776	)
Transfers into Level 3	—	—	
Ending Balance	\$1,987	\$2,449	

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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 or in default will cure such positions.

The table below presents a reconciliation of the Company's financial assets and liabilities measured at fair value on a nonrecurring basis using significant unobservable inputs (Level 3), which solely relates to impaired loans that were remeasured and reported at fair value through a specific valuation allowance allocation of the allowance for loan losses based upon the fair value of the underlying collateral (in thousands). The fair value of impaired loans is estimated using one of several methods, including collateral value, liquidation value and discounted cash flows. The significant unobservable inputs used in the fair value measurement of collateral for collateral-dependent impaired loans primarily relate to discounts applied to the customers' reported amount of collateral. The amount of collateral discount depends upon the marketability of the underlying collateral. During the six months ended June 30, 2014 and 2013, collateral discounts ranged from 20% to 30%. During the six months ended June 30, 2014 and 2013, the Company had no Level 2 financial assets and liabilities that were measured on a nonrecurring basis.

	Six months ended June 30,	
	2014	2013
Beginning balance	\$11,714	\$10,679
Loans classified as impaired during the period	—	3,085
Specific valuation allowance allocations	—	(750 )
	—	2,335
(Additional) reduction in specific valuation allowance allocations	640	—
Paydowns, payoffs, other activity	(4,604	) (498 )
Ending balance	\$7,750	\$12,516

## Non-Financial Assets and Liabilities

The Company has no non-financial assets or liabilities measured at fair value on a recurring basis. Certain non-financial assets measured at fair value on a non-recurring basis include other real estate owned ("OREO"), which is measured at the lower of cost or fair value, and goodwill and other intangible assets, which are measured at fair value

for impairment assessments.

The table below presents OREO that was remeasured and reported at fair value based on significant unobservable inputs (Level 3) (in thousands):

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	Six months ended June 30,	
	2014	2013
Beginning balance	\$8,470	\$8,162
OREO remeasured at initial recognition:		
Carrying value of foreclosed assets prior to remeasurement	3,264	3,307
Charge-offs recognized in the allowance for loan losses	—	(1,059)
Fair value	3,264	2,248
OREO remeasured subsequent to initial recognition		
Carrying value of foreclosed assets prior to remeasurement	480	85
Fair value	106	65
Write-downs included in other non-interest expense	(374)	) (20)
Acquired	—	3,492
Disposed	(2,232)	) (3,045)
Ending balance	\$9,128	\$10,837

ASC Topic 825 “Financial Instruments” as amended, requires disclosure of fair value information about financial instruments, whether or not recognized in the balance sheet, for which it is practicable to estimate that value. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including discount rate and estimate of future cash flows. In that regard, the derived fair value estimates cannot be substantiated by comparison to independent markets and, in many cases, could not be realized in immediate settlement of the instrument. ASC Topic 825 excludes certain financial instruments and all nonfinancial instruments from its disclosure requirements. Accordingly, the aggregate fair value amounts presented do not represent the underlying value of the Company. The following methods and assumptions were used in estimating fair value for financial instruments:

**Cash and cash equivalents:** Due to their short-term nature, the carrying amounts reported in the consolidated balance sheets approximate fair value.

**Securities:** The fair value of securities, both available-for-sale and held-to-maturity, are generally based on quoted market prices or matrix pricing, which is a mathematical technique used widely in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities’ relationship to other benchmark quoted securities.

**Net loans:** The fair value of the loan portfolio is estimated by discounting the expected future cash flows using the current interest rates at which similar loans would be made to borrowers for the same remaining maturities. Loans were first segregated by type such as commercial, real estate and consumer, and were then further segmented into fixed, adjustable and variable rate categories. Expected future cash flows were projected based on contractual cash flows, adjusted for estimated prepayments.

**Deposits:** The fair values of demand deposits (i.e., interest and noninterest-bearing deposits, regular savings and other money market demand accounts) are, by definition, equal to their carrying values. The fair values of time deposits were estimated using discounted cash flow analyses. The discount rates used were based on rates currently offered for deposits with similar remaining maturities. The fair values of the time deposit liabilities do not take into consideration

the value of the Company's long-term relationships with depositors, which may have significant value.

Short-term debt: Securities sold under agreements to repurchase represent borrowings with original maturities of less than 90 days. The carrying amount of borrowings under purchase agreements approximate their fair value.

Long-term debt: The fair value of long-term borrowings is estimated using discounted cash flow analyses based on the Company's current incremental borrowing rates for similar types of borrowing arrangements and market conditions of similar debt instruments.



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Commitments and letters of credit: The fair values of commitments are estimated based on fees currently charged to enter into similar agreements, taking into consideration the remaining terms of the agreements and the counterparties' credit standing. The fair value of letters of credit is based on fees currently charged for similar agreements or on the estimated cost to terminate them or otherwise settle the obligations with the counterparties at the reporting date. The amounts of fees currently charged on commitments and letters of credit are deemed insignificant, and therefore, the estimated fair values and carrying values have not been reflected in the table below.

The following table represents the estimates of fair value of financial instruments (in thousands). This table excludes financial instruments for which the carrying amount approximates fair value. For short-term financial assets such as cash and cash equivalents, the carrying amount is a reasonable estimate of fair value due to the relatively short time between the origination of the instrument and its expected realization. For financial liabilities such as noninterest-bearing demand, interest-bearing demand and savings deposits, the carrying amount is a reasonable estimate of fair value due to these products having no stated maturity.

	Carrying Amount	Fair Value	Level 1	Level 2	Level 3
June 30, 2014					
Assets:					
Cash and cash equivalents	\$ 110,740	\$ 110,740	\$ 110,740	\$—	\$—
Securities available-for-sale	258,761	258,761	5,357	251,417	1,987
Securities held-to-maturity	96,039	98,461	—	98,461	—
Other securities	14,234	14,234	—	14,234	—
Net loans	2,557,241	2,571,046	—	—	2,571,046
Accrued interest receivable	7,727	7,726	7,726	—	—
Derivative assets	8,383	8,383	—	8,383	—
Liabilities:					
Deposits	2,786,247	2,793,781	1,745,268	1,048,513	—
Short-term debt	133,142	133,149	—	133,149	—
Long-term debt	16,495	16,464	—	16,464	—
Derivative liabilities	8,383	8,383	—	8,383	—
December 31, 2013					
Assets:					
Cash and cash equivalents	85,876	85,876	85,876	—	—
Securities available-for-sale	352,660	352,660	6,158	342,615	3,887
Securities held-to-maturity	4,117	5,335	—	5,335	—
Other securities	13,343	13,343	—	13,343	—
Net loans	2,585,622	2,609,524	—	—	2,609,524
Accrued interest receivable	6,866	6,866	6,866	—	—
Derivative assets	3,538	3,538	—	3,538	—
Liabilities:					
Deposits	2,785,133	2,793,620	1,707,527	1,086,093	—
Short-term debt	137,798	137,801	—	137,801	—
Long-term debt	16,495	16,495	—	16,495	—
Derivative liabilities	3,538	3,538	—	3,538	—



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Note M – Merger Related Costs

During the six months ended June 30, 2013, the Company incurred \$5.6 million of merger-related costs in connection with the acquisition of Community on January 10, 2013. These costs were primarily for severance (\$2.6 million), professional fees (\$1.5 million) and data processing costs (\$1.2 million). No merger related costs were incurred during the six months ended June 30, 2014.

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

Critical Accounting Policies

The accounting policies of the Company conform with U.S. generally accepted accounting principles and require management to make estimates and develop assumptions that affect the amounts reported in the financial statements and related footnotes. These estimates and assumptions are based on information available to management as of the date of the financial statements. Actual results could differ significantly from management's estimates. As this information changes, management's estimates and assumptions used to prepare the Company's financial statements and related disclosures may also change. The most significant accounting policies followed by the Company are presented in Note One to the audited financial statements included in the Company's 2013 Annual Report to Shareholders. The information included in this Quarterly Report on Form 10-Q, including the Consolidated Financial Statements, Notes to Consolidated Financial Statements, and Management's Discussion and Analysis of Financial Condition and Results of Operations, should be read in conjunction with the financial statements and notes thereto included in the 2013 Annual Report of the Company. Based on the valuation techniques used and the sensitivity of financial statement amounts to the methods, assumptions, and estimates underlying those amounts, management has identified the determination of the allowance for loan losses, income taxes, other-than-temporary impairment on investment securities and purchased credit-impaired loans to be the accounting areas that require the most subjective or complex judgments and, as such, could be most subject to revision as new information becomes available.

The section Allowance and Provision for Loan Losses provides management's analysis of the Company's allowance for loan losses and related provision. The allowance for loan losses is maintained at a level that represents management's best estimate of probable losses in the loan portfolio. Management's determination of the adequacy of the allowance for loan losses is based upon an evaluation of individual credits in the loan portfolio, historical loan loss experience, current economic conditions, and other relevant factors. This determination is inherently subjective as it requires material estimates including the amounts and timing of future cash flows expected to be received on impaired loans that may be susceptible to significant change. The allowance for loan losses related to loans considered to be impaired is generally evaluated based on the discounted cash flows using the impaired loan's initial effective interest rate or the fair value of the collateral for certain collateral dependent loans.

The Company is subject to federal and state income taxes in the jurisdictions in which it conducts business. In computing the provision for income taxes, management must make judgments regarding interpretation of laws in those jurisdictions. Because the application of tax laws and regulations for many types of transactions is susceptible to varying interpretations, amounts reported in the financial statements could be changed at a later date upon final determinations by taxing authorities. On a quarterly basis, the Company estimates its annual effective tax rate for the year and uses that rate to provide for income taxes on a year-to-date basis. The amount of unrecognized tax benefits could change over the next twelve months as a result of various factors. However, management cannot currently estimate the range of possible change. The Company is currently open to audit under the statute of limitations by the Internal Revenue Service for the years ended December 31, 2010 through 2012. The Company and its subsidiaries state income tax returns are open to audit under the statute of limitations for the years ended December 31, 2010 through 2012.

On a quarterly basis, the Company performs a review of investment securities to determine if any unrealized losses are other-than-temporarily impaired. Management considers the following, amongst other things, in its determination of the nature of the unrealized losses, (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 and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. The Company continues to actively monitor the market value of these investments along with the financial strength of the issuers behind these securities, as well as its entire investment portfolio. Based on the market information available, the Company believes that the recent declines in market value are temporary and that the Company does not have the intent to sell any of the securities classified as available for sale and believes it is more likely than not that the Company will not have to sell any such securities before recovery of costs. The Company cannot guarantee that such securities will recover and if additional information becomes available in the future to suggest that the losses are other than temporary, the Company may need to record impairment charges in future periods. No impairment charges were recognized during the three and six months ended June 30, 2014 as a result of this review. The Company continues to actively monitor the market values of these investments along with the financial strength of the issuers behind these securities, as well as our entire investment portfolio.

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The Company values purchased credit-impaired loans at fair value in accordance with ASC Topic 310-30. In determining the estimated fair value, management considers 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 these loans, the expected cash flows that exceed the fair value of the loan represent the accretible yield, which is recognized as interest income on a level-yield basis over the expected cash flow periods of the loans. The non-accretible 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 accretible yield, which will result in the recognition of additional interest income over the remaining lives of the loans.

## Financial Summary

### Six months ended June 30, 2014 vs. 2013

The Company reported consolidated net income of \$26.6 million, or \$1.67 per diluted common share, for the six months ended June 30, 2014, compared to \$21.0 million, or \$1.33 per diluted common share, for the six months ended June 30, 2013. Return on average assets ("ROA") was 1.57% and return on average equity ("ROE") was 13.4% for the six months ended June 30, 2014 compared to 1.25% and 11.5%, respectively, for the six months ended June 30, 2013.

The Company's net interest income for the first six months of 2014 decreased \$2.0 million compared to the first six months of 2013 (see Net Interest Income). The Company recorded a provision for loan losses of \$1.8 million for the six months ended June 30, 2014 compared to \$3.7 million for the six months ended June 30, 2013 (see Allowance and Provision for Loan Losses). As further discussed under the caption Non-Interest Income and Expense, non-interest income increased \$0.9 million. Non-interest expenses for the six months ended June 30, 2014 decreased \$5.7 million from the six months ended June 30, 2013.

### Three months ended June 30, 2014 vs. 2013

The Company reported consolidated net income of \$12.8 million, or \$0.80 per diluted common share, for the three months ended June 30, 2014, compared to \$13.0 million, or \$0.82 per diluted common share, for the three months ended June 30, 2013. Return on average assets ("ROA") was 1.50% and return on average equity ("ROE") was 12.8% for the three months ended June 30, 2014 compared to 1.53% and 14.0%, respectively, for the second quarter of 2013.

The Company's net interest income for the second quarter of 2014 decreased \$2.4 million compared to the second quarter of 2013 (see Net Interest Income). The Company recorded a provision for loan losses of \$0.4 million for the second quarter of 2014 compared to \$2.0 million for the second quarter of 2013 (see Allowance and Provision for Loan Losses). As further discussed under the caption Non-Interest Income and Expense, non-interest income increased \$0.9 million from the three months ended June 30, 2013. Non-interest expenses for the three months ended June 30, 2014 increased \$0.3 million from the three months ended June 30, 2013.

## Net Interest Income

### Six months ended June 30, 2014 vs. 2013

The Company's tax equivalent net interest income decreased \$2.0 million, or 3.3%, from \$61.2 million for the six months ended June 30, 2013 to \$59.2 million for the six months ended June 30, 2014. The Company's reported net

interest margin decreased from 4.26% for the six months ended June 30, 2013 to 4.05% for the six months ended June 30, 2014. This is primarily due to the expected decrease in accretion related to the acquisitions of Virginia Savings and Community Bank (\$5.7 million and \$3.6 million, respectively). Excluding the favorable impact of the accretion from the fair value adjustments, the net interest margin for the six months ended June 30, 2014 and 2013 would have been 3.80% and 3.87%, respectively.

Three months ended June 30, 2014 vs. 2013

The Company's tax equivalent net interest income decreased \$2.5 million, or 7.8%, from \$31.5 million for the second quarter of 2013 to \$29.0 million for the second quarter of 2014. The Company's reported net interest margin decreased from 4.35% for the quarter ended June 30, 2013 to 3.95% for the quarter ended June 30, 2014. This is primarily due to the expected decrease in accretion related to the acquisitions of Virginia Savings and Community Bank (\$3.5 million and \$1.5 million, respectively).

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Excluding the favorable impact of the accretion from the fair value adjustments, the net interest margin for the three months ended June 30, 2014 and 2013 would have been 3.75% and 3.86%, respectively.

The following schedule presents the actual and estimated future accretion related to the fair value adjustments on net interest income as a result of the Company's acquisitions (in thousands). The amounts in the table below require management to make significant assumptions based on estimated future default, prepayment and discount rates. Actual performance could be significantly different from that assumed, which could result in actual results being materially different than those estimated below.

Year Ended	Virginia Savings		Community		Total
	Loan Accretion	Certificates of Deposit	Loan Accretion	Certificates of Deposit	
2013	\$3,512	\$542	\$9,907	\$682	\$14,643
1Q 2014	299	131	1,628	93	2,151
2Q 2014	284	135	1,023	52	1,494
Total	583	266	2,651	145	3,645
Remainder 2014 (estimated)	384	270	1,472	105	2,231
2015 (estimated)	492	518	2,276	160	3,446
2016 (estimated)	304	497	1,526	43	2,370



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Table One  
Average Balance Sheets and Net Interest Income  
(In thousands)

Assets	Six months ended June 30,			2013			
	2014 Average Balance	Interest	Yield/ Rate	Average Balance	Interest	Yield/ Rate	
Loan portfolio <sup>(1)</sup> :							
Residential real estate <sup>(2)</sup>	\$1,358,564	\$27,442	4.07	%\$1,283,907	\$27,284	4.29	%
Commercial, financial, and agriculture <sup>(2)</sup>	1,155,235	27,496	4.80	1,139,187	29,845	5.28	
Installment loans to individuals <sup>(2),(3)</sup>	53,340	2,275	8.60	66,649	3,217	9.73	
Previously securitized loans <sup>(4)</sup>	—	1,142	***	—	1,363	***	
Total loans	2,567,139	58,355	4.58	2,489,743	61,709	5.00	
Securities:							
Taxable	345,699	5,933	3.46	338,627	5,382	3.21	
Tax-exempt <sup>(5)</sup>	27,424	859	6.32	32,386	978	6.09	
Total securities	373,123	6,792	3.67	371,013	6,360	3.46	
Deposits in depository institutions	8,970	—	—	8,238	—	—	
Federal funds sold	—	—	—	26,320	21	0.16	
Total interest-earning assets	2,949,232	65,147	4.45	2,895,314	68,090	4.74	
Cash and due from banks	137,232			144,096			
Bank premises and equipment	81,635			81,604			
Other assets	246,804			260,449			
Less: allowance for loan losses	(21,347 )			(19,782 )			
Total assets	\$3,393,556			\$3,361,681			
Liabilities							
Interest-bearing demand deposits	\$611,139	\$341	0.11	%\$607,339	\$358	0.12	%
Savings deposits	626,610	407	0.13	593,880	430	0.15	
Time deposits <sup>(2)</sup>	1,060,887	4,742	0.90	1,111,696	5,634	1.02	
Short-term borrowings	126,067	160	0.26	118,838	149	0.25	
Long-term debt	16,495	301	3.68	16,495	309	3.78	
Total interest-bearing liabilities	2,441,198	5,951	0.49	2,448,248	6,880	0.57	
Noninterest-bearing demand deposits	522,472			508,865			
Other liabilities	33,717			40,142			
Stockholders' equity	396,169			364,426			
Total liabilities and stockholders' equity	\$3,393,556			\$3,361,681			
Net interest income		\$59,196			\$61,210		
Net yield on earning assets			4.05	%		4.26	%

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(1) For purposes of this table, non-accruing loans have been included in average balances and loan fees, which are immaterial, have been included in interest income.

(2) Included in the above table are the following amounts for the accretion of the fair value adjustments related to the acquisitions of Virginia Savings and Community:

	Six months ended June 30, 2014		
	Virginia Savings	Community	Total
Residential real estate	\$258	\$258	\$516
Commercial, financial and agriculture	255	2,039	2,294
Installment loans to individuals	70	354	424
Time deposits	266	145	411
	\$849	\$2,796	\$3,645

	Six months ended June 30, 2013		
	Virginia Savings	Community	Total
Residential real estate	\$519	\$243	\$762
Commercial, financial and agriculture	1,720	1,923	3,643
Installment loans to individuals	80	579	659
Time deposits	300	334	634
	\$2,619	\$3,079	\$5,698

(3) Includes the Company's consumer and DDA overdrafts loan categories.

(4) Effective January 1, 2012, there is no carrying value of the Company's previously securitized loans.

(5) Computed on a fully federal tax-equivalent basis assuming a tax rate of approximately 35%.



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## Table Two

## Rate/Volume Analysis of Changes in Interest Income and Interest Expense

(In thousands)

	Six months ended June 30, 2014 vs. 2013		
	Increase (Decrease)		
	Due to Change In:		
	Volume	Rate	Net
Interest-earning assets:			
Loan portfolio			
Residential real estate	\$1,587	\$(1,429)	)\$158
Commercial, financial, and agriculture	420	(2,769)	)(2,349)
Installment loans to individual	(642)	)(300)	)(942)
Previously securitized loans	—	(221)	)(221)
Total loans	1,365	(4,719)	)(3,354)
Securities:			
Taxable	112	439	551
Tax-exempt <sup>(1)</sup>	(150)	)31	(119)
Total securities	(38)	)470	432
Federal funds sold	(21)	)—	(21)
Total interest-earning assets	\$1,306	\$(4,249)	)(2,943)
Interest-bearing liabilities:			
Interest-bearing demand deposits	\$2	\$(19)	)(17)
Savings deposits	24	(47)	)(23)
Time deposits	(257)	)(635)	)(892)
Short-term borrowings	9	2	11
Long-term debt	—	(8)	)(8)
Total interest-bearing liabilities	\$(222)	)(707)	)(929)
Net Interest Income	\$1,528	\$(3,542)	)(2,014)

(1) Fully federal taxable equivalent using a tax rate of approximately 35%.

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Table Three  
Average Balance Sheets and Net Interest Income  
(In thousands)

Assets	Three months ended June 30, 2014			2013			
	Average Balance	Interest	Yield/ Rate	Average Balance	Interest	Yield/ Rate	
Loan portfolio <sup>(1)</sup> :							
Residential real estate <sup>(2)</sup>	\$1,366,485	\$13,696	4.02	%\$1,290,188	\$13,564	4.22	%
Commercial, financial, and agriculture <sup>(2)</sup>	1,143,001	13,260	4.65	1,156,269	15,654	5.43	
Installment loans to individuals <sup>(2),(3)</sup>	54,115	1,097	8.13	67,426	1,839	10.94	
Previously securitized loans <sup>(4)</sup>	—	568	***	—	714	***	
Total loans	2,563,601	28,621	4.48	2,513,883	31,771	5.07	
Securities:							
Taxable	345,419	2,930	3.40	327,252	2,632	3.23	
Tax-exempt <sup>(5)</sup>	27,343	428	6.28	31,789	479	6.04	
Total securities	372,762	3,358	3.61	359,041	3,111	3.48	
Deposits in depository institutions	9,108	—	—	7,451	—	—	
Federal funds sold	—	—	—	22,747	9	0.16	
Total interest-earning assets	2,945,471	31,979	4.35	2,903,122	34,891	4.82	
Cash and due from banks	149,111			175,837			
Bank premises and equipment	81,061			82,243			
Other assets	247,510			261,552			
Less: allowance for loan losses	(21,474 )			(20,089 )			
Total assets	\$3,401,679			\$3,402,665			
Liabilities							
Interest-bearing demand deposits	\$610,489	\$165	0.11	%\$611,334	\$179	0.12	%
Savings deposits	634,718	198	0.13	603,604	216	0.14	
Time deposits <sup>(2)</sup>	1,051,811	2,374	0.91	1,116,358	2,800	1.01	
Short-term borrowings	133,282	85	0.26	125,729	79	0.25	
Long-term debt	16,495	151	3.67	16,495	153	3.72	
Total interest-bearing liabilities	2,446,795	2,973	0.49	2,473,520	3,427	0.56	
Noninterest-bearing demand deposits	527,679			519,212			
Other liabilities	28,783			37,698			
Stockholders' equity	398,422			372,235			
Total liabilities and stockholders' equity	\$3,401,679			\$3,402,665			
Net interest income		\$29,006			\$31,464		
Net yield on earning assets			3.95	%		4.35	%

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(1) For purposes of this table, non-accruing loans have been included in average balances and loan fees, which are immaterial, have been included in interest income.

(2) Included in the above table are the following amounts for the accretion of the fair value adjustments related to the acquisitions of Virginia Savings and Community:

	Three months ended June 30, 2014		
	Virginia Savings	Community	Total
Residential real estate	\$107	\$143	\$250
Commercial, financial and agriculture	141	715	856
Installment loans to individuals	36	165	201
Time deposits	135	52	187
	\$419	\$1,075	\$1,494

	Three months ended June 30, 2013		
	Virginia Savings	Community	Total
Residential real estate	\$243	\$55	\$298
Commercial, financial and agriculture	1,047	1,313	2,360
Installment loans to individuals	44	519	563
Time deposits	122	174	296
	\$1,456	\$2,061	\$3,517

(3) Includes the Company's consumer and DDA overdrafts loan categories.

(4) Effective January 1, 2012, there is no carrying value of the Company's previously securitized loans.

(5) Computed on a fully federal tax-equivalent basis assuming a tax rate of approximately 35%.



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## Table Four

Rate/Volume Analysis of Changes in Interest Income and Interest Expense  
(In thousands)

	Three months ended June 30, 2014 vs. 2013		
	Increase (Decrease)		
	Due to Change In:		
	Volume	Rate	Net
Interest-earning assets:			
Loan portfolio			
Residential real estate	\$802	\$(670)	)\$132
Commercial, financial, and agriculture	(180)	)(2,214	)(2,394)
Installment loans to individuals	(363)	)(379	)(742)
Previously securitized loans	—	(146)	)(146)
Total loans	259	(3,409)	)(3,150)
Securities:			
Taxable	146	152	298
Tax-exempt <sup>(1)</sup>	(67)	)16	(51)
Total securities	79	168	247
Federal funds sold	(9)	)—	(9)
Total interest-earning assets	\$329	\$(3,241)	)\$ (2,912)
Interest-bearing liabilities:			
Interest-bearing demand deposits	\$—	\$(14)	)\$ (14)
Savings deposits	11	(29)	)(18)
Time deposits	(162)	)(264	)(426)
Short-term borrowings	5	1	6
Long-term debt	—	(2)	)(2)
Total interest-bearing liabilities	\$(146)	)\$ (308)	)\$ (454)
Net Interest Income	\$475	\$(2,933)	)\$ (2,458)

(1) Fully federal taxable equivalent using a tax rate of approximately 35%.

## Loans

The composition of the Company's loan portfolio as of the dates indicated follows:

## Table Five

## Loan Portfolio

(In thousands)

	June 30, 2014	December 31, 2013	June 30, 2013
Residential real estate	\$1,242,972	\$1,204,450	\$1,166,858
Home equity – junior liens	145,452	146,090	141,632
Commercial and industrial	149,442	164,484	138,299
Commercial real estate	993,552	1,040,866	1,023,311
Consumer	42,858	46,402	54,242
DDA overdrafts	3,501	3,905	3,103
Total loans	\$2,577,777	\$2,606,197	\$2,527,445

Loan balances decreased \$28.4 million from December 31, 2013 to June 30, 2014. Residential real estate loans increased \$38.5 million, or 3.2%, from December 31, 2013 to June 30, 2014. Residential real estate loans primarily



consist of: (i) single-family 3 and 5 year adjustable rate mortgages with terms that amortize the loans over periods from 15-30 years and (ii) home equity loans secured by first liens. The Company's mortgage products do not include sub-prime, interest only, or option adjustable

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rate mortgage products. The Company's home equity loans are underwritten differently than 1-4 family residential mortgages with typically less documentation but lower loan-to-value ratios. Home equity loans consist of lines of credit, short-term fixed amortizing loans and non-purchase adjustable rate loans. At June 30, 2014, \$20.1 million of the residential real estate loans were for properties under construction.

Junior lien home equity loans decreased \$0.6 million during the first six months of 2014. Junior lien home equity loans consist of lines of credit, short-term fixed amortizing loans, and non-purchase adjustable rate loans with second lien positions.

Commercial real estate loans decreased \$47.3 million, or 4.5%, from December 31, 2013 to June 30, 2014. At June 30, 2014, \$24.6 million of the commercial real estate loans were for commercial properties under construction. Commercial and industrial loans ("C&I") decreased \$15.0 million from December 31, 2013 to June 30, 2014. During the year ended June 30, 2014, a variety of factors led to the decline in commercial real estate and C&I loans - a \$14 million participation loan was repurchased by the lead bank (a large community bank); a \$9 million loan from an acquisition that was classified as substandard was repaid in full; a financially weak \$9 million loan was refinanced by a smaller competitor that provided the borrower a cash out option; a more competitive lending environment; and various lines of credit experienced balance reductions.

Consumer loans decreased \$3.5 million during the first six months of 2014. The consumer loan portfolio primarily consists of new and used automobile loans, personal loans secured by cash and cash equivalents, unsecured revolving credit products, and other similar types of credit facilities. The Company strategically decided to reduce consumer loans due to the acquisition of an indirect portfolio of loans associated with Community. These loans have higher loss percentages compared to the Company's historical consumer portfolio.

### Allowance and Provision for Loan Losses

Management systematically monitors the loan portfolio and the adequacy of the allowance for loan losses ("ALLL") 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 of the allowance as it relates to these loan types is often based more upon specific credit review, with consideration given to the potential impairment of certain credits and historical loss rates, adjusted for general economic conditions and other inherent risk factors. Conversely, due to the homogeneous nature of the real estate and installment portfolios, the portions of the allowance allocated to those portfolios are primarily based on prior loss history of each portfolio, adjusted for general economic conditions and other inherent risk factors.

In evaluating the adequacy of the ALLL, management considers both quantitative and qualitative factors. Quantitative factors include actual repayment characteristics and loan performance, cash flow analyses, and estimated fair values of underlying collateral. Qualitative factors generally include overall trends within the portfolio, composition of the portfolio, changes in pricing or underwriting, seasoning of the portfolio, and general economic conditions.

The allowance not specifically allocated to individual credits is generally determined by analyzing potential exposure and other qualitative factors that could negatively impact the adequacy of the allowance. Loans not individually evaluated for impairment are grouped by pools with similar risk characteristics and the related historical loss rates are adjusted to reflect current inherent risk factors, such as unemployment, overall economic conditions, concentrations of credit, loan growth, classified and impaired loan trends, staffing, adherence to lending policies, and loss trends.

Determination of the ALLL is subjective in nature and requires management to periodically reassess the validity of its assumptions. Differences between actual losses and estimated losses are assessed such that management can timely modify its evaluation model to ensure that adequate provision has been made for risk in the total loan portfolio.

As a result of the Company's quarterly analysis of the adequacy of the ALLL, the Company recorded a provision for loan losses of \$1.8 million in the first six months of 2014 and \$3.7 million in the first six months of 2013. The provision for loan losses recorded in 2014 reflects the modest growth in the loan portfolio, changes in the quality of the portfolio and general improvement in the Company's historical loss rates used to compute the allowance not specifically allocated to individual credits. Additionally, the improvement in non-performing assets also contributed to a lower provision for loan losses during 2014. Changes in the amount of the provision and related allowance are based on the Company's detailed systematic methodology and are directionally consistent with changes in the composition and quality of the Company's loan portfolio. The Company believes its methodology for determining its ALLL adequately provides for probable losses inherent in the loan portfolio and produces a provision and allowance for loan losses that is directionally consistent with changes in asset quality and loss experience.

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The Company had net charge-offs of \$1.8 million and \$2.5 million for the first six months of 2014 and 2013, respectively. Net charge-offs in the first six months of 2014 consisted primarily of net charge-offs on residential real estate loans of \$0.7 million, commercial real estate loans of \$0.9 million and DDA overdrafts of \$0.2 million.

The Company's ratio of non-performing assets to total loans and other real estate owned decreased from 1.20% at December 31, 2013 to 1.10% at June 30, 2014. Excluded from this ratio are purchased credit-impaired loans in which the Company estimated cash flows and estimated a credit mark. These loans are considered performing loans provided that the loan is performing in accordance with the estimated expectations. Such loans would be considered non-performing loans if the loan's performance deteriorates below the initial expectations. The Company's ratio of non-performing assets to total loans and other real estate owned is less than half of the 2.99% non-performing asset ratio reported by the Company's peer group (bank holding companies with total assets between \$1 and \$5 billion), as of the most recently reported quarter ended December 31, 2013.

The ALLL at June 30, 2014 was \$20.5 million compared to \$20.6 million at December 31, 2013. Below is a summary of the changes in the components of the ALLL from December 31, 2013 to June 30, 2014.

The allowance allocated to the commercial real estate loan portfolio (see Table Nine) decreased \$0.4 million, or 3.51%, from \$10.8 million at December 31, 2013 to \$10.4 million at June 30, 2014. This decrease was mainly attributable to lower loan balances due to a more competitive lending environment coupled with an improvement in historical loss rates.

The allowance related to the commercial and industrial loan portfolio remained flat at \$1.1 million at June 30, 2014 (see Table Seven).

The allowance allocated to the residential real estate portfolio (see Table Nine) increased \$0.4 million from \$6.1 million at December 31, 2013 to \$6.5 million at June 30, 2014. This increase was due to growth in the portfolio.

The allowance allocated to the home equity loan portfolio (see Table Nine) decreased from \$1.7 million at December 31, 2013 to \$1.4 million at June 30, 2014.

The allowance allocated to the consumer loan portfolio (see Table Nine) remained flat at \$0.1 million at June 30, 2014.

The allowance allocated to overdraft deposit accounts (see Table Nine) increased modestly from \$0.9 million at December 31, 2013 to \$1.0 million at June 30, 2014.

Based on the Company's analysis of the adequacy of the allowance for loan losses and in consideration of the known factors utilized in computing the allowance, management believes that the allowance for loan losses as of June 30, 2014, is adequate to provide for probable losses inherent in the Company's loan portfolio. Future provisions for loan losses will be dependent upon trends in loan balances including the composition of the loan portfolio, changes in loan quality and loss experience trends, and recoveries of previously charged-off loans, among other factors.



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Table Six  
Analysis of the Allowance for Loan Losses  
(In thousands)

	Six months ended June 30,		Year ended December 31,	
	2014	2013	2013	
Balance at beginning of period	\$20,575	\$18,809	\$18,809	
Charge-offs:				
Commercial and industrial	5	392	1,040	
Commercial real estate	969	622	2,187	
Residential real estate	743	1,111	2,181	
Home equity	146	270	295	
Consumer	122	224	454	
DDA overdrafts	662	687	1,483	
Total charge-offs	2,647	3,306	7,640	
Recoveries:				
Commercial and industrial	81	21	84	
Commercial real estate	83	34	785	
Residential real estate	63	68	234	
Home equity	—	—	—	
Consumer	129	217	327	
DDA overdrafts	454	477	1,128	
Total recoveries	810	817	2,558	
Net charge-offs	1,837	2,489	5,082	
Provision for acquired loans	138	177	597	
Provision for loan losses	1,660	3,572	6,251	
Balance at end of period	\$20,536	\$20,069	\$20,575	
As a Percent of Average Total Loans:				
Net charge-offs (annualized)	0.14	% 0.20	% 0.20	%
Provision for loan losses (annualized)	0.14	% 0.30	% 0.27	%
As a Percent of Non-Performing Loans:				
Allowance for loan losses	106.86	% 119.63	% 90.25	%

Table Seven  
Non-Accrual, Past-Due and Restructured Loans  
(In thousands)

	As of June 30,		December 31,	
	2014	2013	2013	
Non-accrual loans	\$18,423	\$15,706	\$22,361	
Accruing loans past due 90 days or more	794	1,070	436	
Total non-performing loans	19,217	16,776	22,797	

The average recorded investment in impaired loans during the six months ended June 30, 2014 and 2013 was \$10.9 million and \$13.3 million, respectively. The Company recognized less than \$0.1 million of interest income received in cash on non-accrual and impaired loans for the six months ended June 30, 2014. There was no interest income received in cash on non-accrual and impaired loans for the three months ended June 30, 2013. Approximately \$0.2 million of interest income would have been recognized during both the six months ended June 30, 2014 and June 30,

2013, if such loans had been current in accordance with their original terms. There were no commitments to provide additional funds on non-accrual, impaired, or other potential problem loans at June 30, 2014.

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Interest on loans is accrued and credited to operations based upon the principal amount outstanding. The accrual of interest income is generally discontinued when a loan becomes 90 days past due as to principal or interest unless the loan is well collateralized and in the process of collection. When interest accruals are discontinued, interest credited to income in the current year that is unpaid and deemed uncollectible is charged to operations. Prior-year interest accruals that are unpaid and deemed uncollectible are charged to the allowance for loan losses, provided that such amounts were specifically reserved.

Table Eight  
Impaired Loans  
(In thousands)

	As of June 30,		As of December
	2014	2013	31, 2013
Impaired loans with a valuation allowance	\$1,403	\$3,085	\$3,416
Impaired loans with no valuation allowance	6,587	10,181	9,178
Total impaired loans	\$7,990	\$13,266	\$12,594
Allowance for loan losses allocated to impaired loans	\$240	\$750	\$880

Table Nine  
Allocation of the Allowance for Loan Losses  
(In thousands)

	As of June 30,		As of December
	2014	2013	31, 2013
Commercial and industrial	\$1,105	\$1,066	\$1,139
Commercial real estate	10,397	10,494	10,775
Residential real estate	6,464	5,978	6,057
Home equity	1,443	1,651	1,672
Consumer	81	81	77
DDA overdrafts	1,046	799	855
Allowance for Loan Losses	\$20,536	\$20,069	\$20,575

## Non-Interest Income and Non-Interest Expense

Six months ended June 30, 2014 vs. 2013  
(In thousands)

	Six months ended June 30,		\$ Change	% Change
	2014	2013		
Gains on sale of investment securities	\$0.9	\$0.1	\$0.8	800.0 %
Non-interest income, excluding gains on sale of investment securities	28.5	28.5	—	— %
Non-interest expense	47.7	53.4	(5.7)	(10.7)%

Non-Interest Income: During 2014, the Company realized investment gains of \$0.9 million from the sale of certain equity positions related to community banks and bank holding companies. Excluding investment security gains,



non-interest income remained flat at \$28.5 million compared to the first six months of 2013.

Non-Interest Expense: During 2013, the Company completed its acquisition of Community and recognized \$5.6 million of acquisition and integration expenses. Excluding these expenses, non-interest expenses decreased \$0.1 million, from \$47.8 million in the first six months of 2013 to \$47.7 million in the first six months of 2014. This decrease was largely attributable to a decline in other expenses of \$1.6 million due to a decrease in non-income based taxes as a result of the recognition of previously

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unrecognized tax position resulting from the close of the statute of limitations for a previous tax year. This favorable difference was discrete to the first quarter of 2014. This decrease was partially offset by an increase in repossessed asset losses of \$0.7 million and salaries and employee benefits of \$0.5 million.

Income Tax Expense: The Company's effective income tax rate for the six months ended June 30, 2014 was 31.7% compared to 34.4% for the year ended December 31, 2013, and 35.1% for the six months ended June 30, 2013. During the six months ended June 30, 2014, the Company reduced income tax expense due to the recognition of previously unrecognized tax position resulting from the close of the statute of limitations for a previous tax year. Exclusive of this discrete item recognized in the six months ended June 30, 2014, the Company's tax rate from operations was 33.6%.

In the preparation of income tax returns, tax positions are taken based on interpretations of Federal and state income tax laws, for which the outcome of such positions may not be certain. The Company periodically reviews and evaluates the status of uncertain tax positions and may establish tax reserves for tax benefits that may not be realized. The amount of any such reserves are based on the standards for determining such reserves as set forth in current accounting guidance and the Company's estimate the amounts that may ultimately be due or owed (including interest). These estimates may change from time to time based on the Company's evaluation of developments subsequent to the filing of the income tax return, such as tax authority audits, court decisions, other tax law interpretations, or the closing of the statute of limitations. During the first quarter of 2014, the Company recognized \$1.3 million of unrecognized tax benefits due to the expiration of the statute of limitations on certain items. The Company may release another \$1.5 million over the next 12 months from its unrecognized tax benefit balance due to the expiration of the applicable statute of limitations, although there can be no assurances that this will occur.

Three months ended June 30, 2014 vs. 2013

(In thousands)

	Three months ended June 30,			
	2014	2013	\$ Change	% Change
Gains on sale of investment securities	\$0.8	\$—	\$0.8	-
Non-interest income, excluding gains on sale of investment securities	14.3	14.2	0.1	0.7 %
Non-interest expense	24.3	24.0	0.3	1.3 %

Non-Interest Income: During the second quarter of 2014, the Company realized investment gains of \$0.8 million from the sale of certain equity positions related to community banks and bank holding companies. Excluding investment security gains, non-interest income increased \$0.1 million to \$14.3 million in the second quarter of 2014. Bankcard revenues increased \$0.4 million, or 11.2%, due to increased usage by our customers from the second quarter of 2013 and trust and investment management fee income increased \$0.1 million or 15.2% to \$1.1 million in the second quarter of 2014. These increases were partially offset by a decrease in other income of \$0.2 million from the second quarter of 2013 due to a decline in fixed rate mortgage lending activity and service charges were down as a result of a sluggish economy.

Non-Interest Expense: Non-interest expenses increased \$0.3 million, from \$24.0 million in the second quarter of 2013 to \$24.3 million in the second quarter of 2014. This increase was primarily related to higher salaries and employee benefits of \$0.3 million, repossessed asset losses of \$0.2 million and advertising of \$0.1 million. These expenses were partially offset by a decrease in other expenses of \$0.3 million.

Income Tax Expense: The Company's effective income tax rate for the three months ended June 30, 2014 was 33.7% compared to 34.4% for the year ended December 31, 2013, and 33.6% for the three months ended June 30, 2013. The effective rate is based upon the Company's expected tax rate for the year ending December 31, 2014.

## Risk Management

Market risk is the risk of loss due to adverse changes in current and future cash flows, fair values, earnings or capital due to adverse movements in interest rates and other factors, including foreign exchange rates and commodity prices. Because the Company has no significant foreign exchange activities and holds no commodities, interest rate risk represents the primary risk factor affecting the Company's balance sheet and net interest margin. Significant changes in interest rates by the Federal Reserve could result in similar changes in LIBOR interest rates, prime rates, and other benchmark interest rates that could affect the estimated fair value of the Company's investment securities portfolio, interest paid on the Company's short-term and long-term borrowings, interest earned on the Company's loan portfolio and interest paid on its deposit accounts.

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The Company's Asset and Liability Committee ("ALCO") has been delegated the responsibility of managing the Company's interest-sensitive balance sheet accounts to maximize earnings while managing interest rate risk. ALCO, comprised of various members of executive and senior management, is also responsible for establishing policies to monitor and limit the Company's exposure to interest rate risk and to manage the Company's liquidity position. ALCO satisfies its responsibilities through monthly meetings during which product pricing issues, liquidity measures, and interest sensitivity positions are monitored.

In order to measure and manage its interest rate risk, the Company uses an asset/liability management and simulation software model to periodically update the interest sensitivity position of the Company's balance sheet. The model is also used to perform analyses that measure the impact on net interest income and capital as a result of various changes in the interest rate environment. Such analyses quantify the effects of various interest rate scenarios on projected net interest income.

The Company's policy objective is to avoid negative fluctuations in net income or the economic value of equity of more than 15% within a 12-month period, assuming an immediate parallel increase or decrease of 400 basis points. The Company measures the long-term risk associated with sustained increases and decreases in rates through analysis of the impact to changes in rates on the economic value of equity. Due to the current Federal Funds target rate of 25 basis points, the Company has chosen not to reflect a decrease of 25 basis points from current rates in its analysis.

The following table summarizes the sensitivity of the Company's net income to various interest rate scenarios. The results of the sensitivity analyses presented below differ from the results used internally by ALCO in that, in the analyses below, interest rates are assumed to have an immediate and sustained parallel shock. The Company recognizes that rates are volatile, but rarely move with immediate and parallel effects. Internally, the Company considers a variety of interest rate scenarios that are deemed to be possible while considering the level of risk it is willing to assume in "worst-case" scenarios such as shown by the following:

Immediate Basis Point Change in Interest Rates	Implied Federal Funds Rate Associated with Change in Interest Rates	Estimated Increase (Decrease) in Net Income Over 12 Months	Estimated Increase (Decrease) in Economic Value of Equity
June 30, 2014			
+400	4.25	% +3.4	% (1.7 )%
+300	3.25	+4.5	+1.7
+200	2.25	+3.9	+3.5
+100	1.25	+1.2	+1.8
December 31, 2013			
+400	4.25	% +3.3	% (6.4 )%
+300	3.25	+4.3	(2.0 )
+200	2.25	+3.3	+0.6
+100	1.25	+0.6	+0.4

These estimates are highly dependent upon assumptions made by management, including, but not limited to, assumptions regarding the manner in which interest-bearing demand deposit and saving deposit accounts reprice in different interest rate scenarios, changes in the composition of deposit balances, pricing behavior of competitors, prepayments of loans and deposits under alternative rate environments, and new business volumes and pricing. As a result, there can be no assurance that the estimates above will be achieved in the event that interest rates increase during 2014 and beyond. The estimates above do not necessarily imply that the Company will experience increases in net income if market interest rates rise. The table above indicates how the Company's net income and the economic value of equity behave relative to an increase or decrease in rates compared to what would otherwise occur if rates

remain stable.

Based upon the estimates above, the Company believes that its net income is positively correlated with increasing rates as compared to the level of net income the Company would expect if interest rates remain flat.

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Liquidity

The Company evaluates the adequacy of liquidity at both the Parent Company level and at the banking subsidiary level. At the Parent Company level, the principal source of cash is dividends from its banking subsidiary, City National Bank ("City National"). Dividends paid by City National to the Parent Company are subject to certain legal and regulatory limitations. Generally, any dividends in amounts that exceed the earnings retained by City National in the current year plus retained net profits for the preceding two years must be approved by regulatory authorities. At June 30, 2014, City National could pay dividends up to \$25.8 million plus net profits for the remainder of 2014, as defined by statute, up to the dividend declaration date without prior regulatory permission.

The Parent Company used cash obtained from the dividends received primarily to: (1) pay common dividends to shareholders, (2) remit interest payments on the Company's junior subordinated debentures, and (3) fund repurchase of the Company's common shares.

Over the next 12 months, the Parent Company has an obligation to remit interest payments approximating \$0.6 million on the junior subordinated debentures held by City Holding Capital Trust III. Additionally, the Parent Company anticipates continuing the payment of dividends, which are expected to approximate \$25.0 million on an annualized basis over the next 12 months based on common shareholders of record at June 30, 2014. However, interest payments on the debentures can be deferred for up to five years under certain circumstances and dividends to shareholders can, if necessary, be suspended. In addition to these anticipated cash needs, the Parent Company has operating expenses and other contractual obligations, which are estimated to require \$1.6 million of additional cash over the next 12 months. As of June 30, 2014, the Parent Company reported a cash balance of \$9.4 million and management believes that the Parent Company's available cash balance, together with cash dividends from City National will be adequate to satisfy its funding and cash needs over the next twelve months.

Excluding the interest and dividend payments discussed above, the Parent Company has no significant commitments or obligations in years after 2014 other than the repayment of its \$16.5 million obligation under the debentures held by City Holding Capital Trust III. However, this obligation does not mature until June 2038, or earlier at the option of the Parent Company. It is expected that the Parent Company will be able to obtain the necessary cash, either through dividends obtained from City National or the issuance of other debt, to fully repay the debentures at their maturity.

City National manages its liquidity position in an effort to effectively and economically satisfy the funding needs of its customers and to accommodate the scheduled repayment of borrowings. Funds are available to City National from a number of sources, including depository relationships, sales and maturities within the investment securities portfolio, and borrowings from the FHLB and other financial institutions. As of June 30, 2014, City National's assets are significantly funded by deposits and capital. Additionally, City National maintains borrowing facilities with the FHLB and other financial institutions that are accessed as necessary to fund operations and to provide contingency funding mechanisms. As of June 30, 2014, City National has the capacity to borrow an additional \$1.5 billion from the FHLB and other financial institutions under existing borrowing facilities. City National maintains a contingency funding plan, incorporating these borrowing facilities, to address liquidity needs in the event of an institution-specific or systemic financial industry crisis. Also, although it has no current intention to do so, City National could liquidate its unpledged securities, if necessary, to provide an additional funding source. City National also segregates certain mortgage loans, mortgage-backed securities, and other investment securities in a separate subsidiary so that it can separately monitor the asset quality of these primarily mortgage-related assets, which could be used to raise cash through securitization transactions or obtain additional equity or debt financing if necessary.

The Company manages its asset and liability mix to balance its desire to maximize net interest income against its desire to minimize risks associated with capitalization, interest rate volatility, and liquidity. With respect to liquidity, the Company has chosen a conservative posture and believes that its liquidity position is strong. The Company's net

loan to asset ratio is 76.0% as of June 30, 2014 and deposit balances fund 82.8% of total assets. The Company has obligations to extend credit, but these obligations are primarily associated with existing home equity loans that have predictable borrowing patterns across the portfolio. The Company has investment security balances with carrying values that totaled \$369.0 million million at June 30, 2014, and that greatly exceeded the Company's non-deposit sources of borrowing which totaled \$149.6 million. Further, the Company's deposit mix has a very high proportion of transaction and savings accounts that fund 51.9% of the Company's total assets.

As illustrated in the Consolidated Statements of Cash Flows, the Company generated \$14.0 million of cash from operating activities during the first six months of 2014, primarily from interest income received on loans and investments, net of interest expense paid on deposits and borrowings. The Company generated \$34.0 million of cash in investing activities during the first six months of 2014 primarily from the repayment of loans. The Company used \$23.1 million of cash in financing activities during the first six months of 2014, principally a result of purchases of treasury stock of \$8.4 million, as well as cash dividends paid to the Company's common stockholders of \$12.1 million.

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## Capital Resources

During the first six months of 2014, Shareholders' Equity increased \$9.6 million, or 2.5%, from \$387.6 million at December 31, 2013 to \$397.2 million at June 30, 2014. This increase was primarily due to net income of \$26.6 million, partially offset by dividends declared of \$12.5 million.

Regulatory guidelines require the Company to maintain a minimum total capital to risk-adjusted assets ratio of 8.0%, with at least one-half of capital consisting of tangible common stockholders' equity and a minimum Tier I leverage ratio of 4.0%. Similarly, City National Bank is also required to maintain minimum capital levels as set forth by various regulatory agencies. Under capital adequacy guidelines, City National Bank is required to maintain minimum total capital, Tier I capital, and leverage ratios of 8.0%, 4.0%, and 4.0%, respectively. To be classified as "well capitalized," City National Bank must maintain total capital, Tier I capital, and leverage ratios of 10.0%, 6.0%, and 5.0%, respectively.

The Company's regulatory capital ratios for both City Holding and City National Bank as illustrated in the following table:

	Minimum	Well-Capitalized	Actual June 30, 2014	December 31, 2013	
City Holding:					
Total	8.0	% 10.0	% 14.5	% 13.8	%
Tier I Risk-based	4.0	6.0	13.7	13.0	
Tier I Leverage	4.0	5.0	10.2	9.8	
City National Bank:					
Total	8.0	% 10.0	% 13.7	% 12.2	%
Tier I Risk-based	4.0	6.0	12.9	11.4	
Tier I Leverage	4.0	5.0	9.5	8.6	

As of June 30, 2014, management believes that City Holding Company, and its banking subsidiary, City National Bank, were "well capitalized." City Holding is subject to regulatory capital requirements administered by the Federal Reserve, while City National Bank is subject to regulatory capital requirements administered by the Office of the Comptroller of the Currency ("OCC") and the Federal Deposit Insurance Corporation ("FDIC"). Regulatory agencies can initiate certain mandatory actions if either City Holding or City National Bank fails to meet the minimum capital requirements, as shown above. As of June 30, 2014, management believes that City Holding and City National Bank meet all capital adequacy requirements.

In July 2013, the Federal Reserve published the final rules that establish a new comprehensive capital framework for banking organizations, commonly referred to as Basel III. These final rules substantially revise the risk-based capital requirements applicable to bank holding companies and depository institutions. The final rule is effective January 1, 2015 for smaller, non-complex banking organizations with full implementation by January 1, 2019.

## Item 3 - Quantitative and Qualitative Disclosure About Market Risk

The information called for by this item is provided under the caption "Risk Management" under Item 2—Management's Discussion and Analysis of Financial Condition and Results of Operations.

## Item 4 - Controls and Procedures



Pursuant to Rule 13a-15(b) under the Securities Exchange Act of 1934, the Company carried out an evaluation, with the participation of the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the Company's disclosure controls and procedures (as defined under Rule 13a-15(e) under the Securities Exchange Act of 1934) as of the end of the period covered by this report. Based upon that evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective in timely alerting them to material information relating to the Company required to be included in the Company's periodic SEC filings. There has been no change in the Company's internal control over financial reporting during the quarter ended June 30, 2014 that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

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## Part II - OTHER INFORMATION

## Item 1. Legal Proceedings

The Company is engaged in various legal actions that it deems to be in the ordinary course of business. As these legal actions are resolved, the Company could realize positive and/or negative impact to its financial performance in the period in which these legal actions are ultimately decided. There can be no assurance that current actions will have immaterial results, either positive or negative, or that no material actions may be presented in the future.

## Item 1A. Risk Factors

There have been no material changes to the factors disclosed in Item 1A. Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2013.

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

The following table sets forth information regarding the Company's common stock repurchases transacted during the quarter:

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs
April 1 - April 30, 2014	9,681	\$42.50	9,681	376,662
May 1 - May 31, 2014	86,101	\$42.26	86,101	290,561
June 1 - June 30, 2014	30,724	\$44.86	30,724	259,837

## Item 3. Defaults Upon Senior Securities.

None.

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Item 4. Mine Safety Disclosures.

None.

Item 5. Other Information.

None.

Item 6. Exhibits

(a) Exhibits

- 31(a) Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 for Charles R. Hageboeck
- 31(b) Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 for David L. Bumgarner
- 32(a) Certification pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 for Charles R. Hageboeck
- 32(b) Certification pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 for David L. Bumgarner
- 101.INS XBRL Instance Document\*
- 101.SCH XBRL Taxonomy Extension Schema\*
- 101.CAL XBRL Taxonomy Extension Calculation Linkbase\*
- 101.DEF XBRL Taxonomy Extension Definition Linkbase\*
- 101.LAB XBRL Taxonomy Extension Label Linkbase\*
- 101.PRE XBRL Taxonomy Extension Presentation Linkbase\*

Pursuant to Rule 406T of Regulation S-T, these interactive data files are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933 or Section 18 of the Securities Exchange Act of 1934 and otherwise are not subject to liability.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

City Holding Company  
(Registrant)

/s/ Charles R. Hageboeck  
Charles R. Hageboeck  
President and Chief Executive Officer  
(Principal Executive Officer)

/s/ David L. Bumgarner  
David L. Bumgarner  
Senior Vice President, Chief Financial Officer and Principal Accounting Officer  
(Principal Financial Officer)

Date: August 7, 2014

