

CITY HOLDING CO  
Form 10-Q  
August 09, 2012

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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, 2012

OR

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

For The Transition Period From \_\_\_\_\_ To \_\_\_\_\_.

Commission File number 0-11733

CITY HOLDING COMPANY  
(Exact name of registrant as specified in its charter)

West Virginia  
(State or other jurisdiction of  
incorporation or organization)

55-0619957  
(I.R.S. Employer Identification  
No.)

25 Gateway Road  
Charleston, West Virginia  
(Address of principal executive  
offices)

25313  
(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

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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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

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 – 14,820,633 shares as of August 3, 2012.

## 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 our financial condition and results of operations; (12) continued deterioration in the financial condition of the U.S. banking system may impact the valuations of investments the Company has made in the 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") recently adopted by the United States Congress. 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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## PART I, ITEM 1 – FINANCIAL STATEMENTS

## Consolidated Balance Sheets

## City Holding Company and Subsidiaries

(in thousands)

|   | June 30<br>2012<br>(Unaudited) | December<br>31<br>2011 |
|---|--------------------------------|------------------------|
| <b>Assets</b>   |                                |                        |
| Cash and due from banks   | \$ 90,630                      | \$ 140,873             |
| Interest-bearing deposits in depository institutions  | 8,410                          | 5,526                  |
| Federal funds sold  | 35,000                         | -                      |
| Cash and Cash Equivalents   | 134,040                        | 146,399                |
| Investment securities available for sale, at fair value   | 376,891                        | 360,783                |
| Investment securities held-to-maturity, at amortized cost (approximate fair value at June 30, 2012 and December 31, 2011 - \$19,627 and \$23,423, respectively) | 19,319                         | 23,458                 |
| Other securities  | 11,686                         | 11,934                 |
| <b>Total Investment Securities</b>  | <b>407,896</b>                 | <b>396,175</b>         |
| Gross loans   | 2,065,589                      | 1,973,103              |
| Allowance for loan losses   | (19,452 )                      | (19,409 )              |
| <b>Net Loans</b>  | <b>2,046,137</b>               | <b>1,953,694</b>       |
| Bank owned life insurance   | 80,407                         | 78,961                 |
| Premises and equipment, net   | 72,516                         | 64,612                 |
| Accrued interest receivable   | 7,090                          | 7,093                  |
| Net deferred tax asset  | 34,716                         | 32,219                 |
| Goodwill and other intangible assets  | 65,162                         | 56,164                 |
| Other assets  | 45,502                         | 41,792                 |
| <b>Total Assets</b>   | <b>\$ 2,893,466</b>            | <b>\$ 2,777,109</b>    |
| <b>Liabilities</b>  |                                |                        |
| <b>Deposits:</b>  |                                |                        |
| Noninterest-bearing   | \$ 421,664                     | \$ 369,025             |
| <b>Interest-bearing:</b>  |                                |                        |
| Demand deposits   | 543,623                        | 526,824                |
| Savings deposits  | 498,815                        | 439,823                |
| Time deposits   | 931,278                        | 885,596                |
| <b>Total Deposits</b>   | <b>2,395,380</b>               | <b>2,221,268</b>       |
| <b>Short-term borrowings:</b>   |                                |                        |
| Federal funds purchased   | -                              | 75,000                 |
| Customer repurchase agreements  | 123,074                        | 114,050                |
| Long-term debt  | 16,495                         | 16,495                 |
| Other liabilities   | 37,895                         | 39,162                 |
| <b>Total Liabilities</b>  | <b>2,572,844</b>               | <b>2,465,975</b>       |

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Shareholders' Equity

|  |              |              |
|--|--------------|--------------|
| 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, 2012 and December 31, 2011, less 3,678,649 and 3,717,993 shares in treasury, respectively | 46,249       | 46,249       |
| Capital surplus  | 103,449      | 103,335      |
| Retained earnings  | 298,155      | 291,050      |
| Cost of common stock in treasury   | (124,754 )   | (125,593 )   |
| Accumulated other comprehensive income (loss):   |              |              |
| Unrealized gain on securities available-for-sale   | 2,255        | 825          |
| Underfunded pension liability  | (4,732 )     | (4,732 )     |
| Total Accumulated Other Comprehensive Loss   | (2,477 )     | (3,907 )     |
| Total Shareholders' Equity   | 320,622      | 311,134      |
| Total Liabilities and Shareholders' Equity   | \$ 2,893,466 | \$ 2,777,109 |

See notes to consolidated financial statements.

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

|  | Three months Ended<br>June 30 |          | Six months Ended June<br>30 |          |
|--|-------------------------------|----------|-----------------------------|----------|
|  | 2012                          | 2011     | 2012                        | 2011     |
| <b>Interest Income</b>   |                               |          |                             |          |
| Interest and fees on loans   | \$23,143                      | \$23,352 | \$46,210                    | \$47,090 |
| Interest on investment securities:                                   |                               |          |                             |          |
| Taxable  | 3,943                         | 4,513    | 7,907                       | 9,055    |
| Tax-exempt   | 368                           | 445      | 755                         | 907      |
| Interest on federal funds sold                                       | 12                            | 13       | 23                          | 26       |
| Total Interest Income  | 27,466                        | 28,323   | 54,895                      | 57,078   |
| <b>Interest Expense</b>  |                               |          |                             |          |
| Interest on deposits   | 3,383                         | 5,568    | 7,051                       | 11,279   |
| Interest on short-term borrowings                                    | 77                            | 77       | 150                         | 149      |
| Interest on long-term debt   | 165                           | 158      | 333                         | 315      |
| Total Interest Expense   | 3,625                         | 5,803    | 7,534                       | 11,743   |
| Net Interest Income  | 23,841                        | 22,520   | 47,361                      | 45,335   |
| Provision for loan losses  | 1,675                         | 1,286    | 3,625                       | 2,372    |
| Net Interest Income After Provision for Loan Losses                  | 22,166                        | 21,234   | 43,736                      | 42,963   |
| <b>Non-interest Income</b>   |                               |          |                             |          |
| Total investment securities impairment losses                        | (606 )                        | -        | (606 )                      | -        |
| Noncredit impairment losses recognized in other comprehensive income | 302                           | -        | 302                         | -        |
| Net investment securities impairment losses                          | (304 )                        | -        | (304 )                      | -        |
| Gain on sale of investment securities                                | 832                           | 3,128    | 801                         | 3,128    |
| Net investment securities gain                                       | 528                           | 3,128    | 497                         | 3,128    |
| Service charges  | 9,649                         | 9,855    | 18,739                      | 18,909   |
| Insurance commissions  | 1,347                         | 1,504    | 3,343                       | 3,125    |
| Trust and investment management fee income                           | 942                           | 730      | 1,749                       | 1,483    |
| Bank owned life insurance  | 766                           | 745      | 1,489                       | 1,503    |
| Other income   | 558                           | 575      | 1,091                       | 1,051    |
| Total Non-interest Income  | 13,790                        | 16,537   | 26,908                      | 29,199   |
| <b>Non-interest Expense</b>  |                               |          |                             |          |
| Salaries and employee benefits                                       | 10,668                        | 10,183   | 20,913                      | 20,095   |
| Occupancy and equipment  | 1,978                         | 1,921    | 3,913                       | 4,027    |
| Depreciation   | 1,109                         | 1,140    | 2,195                       | 2,276    |
| FDIC insurance expense   | 394                           | 932      | 779                         | 1,884    |
| Advertising  | 675                           | 628      | 1,319                       | 1,308    |
| Bankcard expenses  | 694                           | 633      | 1,314                       | 1,134    |

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|  |         |         |          |          |
|--|---------|---------|----------|----------|
| Postage, delivery, and statement mailings        | 488     | 510     | 1,036    | 1,064    |
| Office supplies                                  | 396     | 452     | 851      | 991      |
| Legal and professional fees                      | 421     | 3,511   | 738      | 3,980    |
| Telecommunications                               | 387     | 417     | 776      | 846      |
| Reposessed asset losses (gains), net of expenses | 650     | (7 )    | 771      | 191      |
| Merger related costs                             | 4,042   | -       | 4,177    | -        |
| Other expenses                                   | 2,861   | 2,592   | 5,496    | 4,974    |
| Total Non-interest Expense                       | 24,763  | 22,912  | 44,278   | 42,770   |
| Income Before Income Taxes                       | 11,193  | 14,859  | 26,366   | 29,392   |
| Income tax expense                               | 3,780   | 5,029   | 8,924    | 9,947    |
| Net Income Available to Common Shareholders      | \$7,413 | \$9,830 | \$17,442 | \$19,445 |
| Total comprehensive income                       | \$6,673 | \$9,897 | \$18,872 | \$20,104 |
| Average common shares outstanding                | 14,680  | 15,120  | 14,676   | 15,244   |
| Effect of dilutive securities:                   |         |         |          |          |
| Employee stock options                           | 79      | 73      | 84       | 78       |
| Shares for diluted earnings per share            | 14,759  | 15,193  | 14,760   | 15,322   |
| Basic earnings per common share                  | \$0.50  | \$0.65  | \$1.18   | \$1.27   |
| Diluted earnings per common share                | \$0.50  | \$0.64  | \$1.17   | \$1.26   |
| Dividends declared per common share              | \$0.35  | \$0.34  | \$0.70   | \$0.68   |

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, 2012 and 2011  
 (in thousands)

|   | Common<br>Stock | Capital<br>Surplus | Retained<br>Earnings | Treasury<br>Stock | Accumulated<br>Other<br>Comprehensive<br>Income<br>(Loss) | Total<br>Shareholders'<br>Equity |
|---|-----------------|--------------------|----------------------|-------------------|---|----------------------------------|
| Balances at December<br>31, 2010              | \$46,249        | \$103,057          | \$270,905            | \$(102,853)       | \$ (2,497 )   | \$ 314,861                       |
| Net income                                    |                 |                    | 19,445               |                   |   | 19,445                           |
| Other comprehensive<br>income                 |                 |                    |                      |                   | 659   | 659                              |
| Cash dividends declared<br>(\$0.68 per share) |                 |                    | (10,319 )            |                   |   | (10,319 )                        |
| Stock-based<br>compensation expense,<br>net   |                 | (119 )             |                      | 784               |   | 665                              |
| Exercise of 5,476 stock<br>options            |                 | -                  |                      | 153               |   | 153                              |
| Purchase of 447,524<br>treasury shares        |                 |                    |                      | (15,085 )         |   | (15,085 )                        |
| Balances at June 30,<br>2011                  | \$46,249        | \$102,938          | \$280,031            | \$(117,001)       | \$ (1,838 )   | \$ 310,379                       |

|   | Common<br>Stock | Capital<br>Surplus | Retained<br>Earnings | Treasury<br>Stock | Accumulated<br>Other<br>Comprehensive<br>Income<br>(Loss) | Total<br>Shareholders'<br>Equity |
|---|-----------------|--------------------|----------------------|-------------------|---|----------------------------------|
| Balances at December<br>31, 2011              | \$46,249        | \$103,335          | \$291,050            | \$(125,593)       | \$ (3,907 )   | \$ 311,134                       |
| Net income                                    |                 |                    | 17,442               |                   |   | 17,442                           |
| Other comprehensive<br>income                 |                 |                    |                      |                   | 1,430   | 1,430                            |
| Acquisition of Virginia<br>Savings Bancorp    |                 | 276                |                      | 7,447             |   | 7,723                            |
| Cash dividends declared<br>(\$0.70 per share) |                 |                    | (10,337 )            |                   |   | (10,337 )                        |
| Stock-based<br>compensation expense,<br>net   |                 | (49 )              |                      | 706               |   | 657                              |
|   |                 | (113 )             |                      | 601               |   | 488                              |

|                                     |          |           |           |              |             |            |
|-------------------------------------|----------|-----------|-----------|--------------|-------------|------------|
| Exercise of 16,899 stock options    |          |           |           |              |             |            |
| Purchase of 237,535 treasury shares |          |           |           | (7,915 )     |             | (7,915 )   |
| Balances at June 30, 2012           | \$46,249 | \$103,449 | \$298,155 | \$(124,754 ) | \$ (2,477 ) | \$ 320,622 |

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<br>30 |                  |
|---|-----------------------------|------------------|
|   | 2012                        | 2011             |
| <b>Operating Activities</b>   |                             |                  |
| Net income  | \$17,442                    | \$19,445         |
| Adjustments to reconcile net income to net cash provided by operating activities: |                             |                  |
| Amortization and accretion  | 1,412                       | 810              |
| Provision for loan losses   | 3,625                       | 2,372            |
| Depreciation of premises and equipment  | 2,195                       | 2,276            |
| Deferred income tax expense (benefit)   | 263                         | (1,271 )         |
| Accretion of gain from sale of interest rate floors                               | -                           | (295 )           |
| Net periodic employee benefit cost  | 262                         | 192              |
| Net realized investment securities (gains)  | (497 )                      | (3,128 )         |
| Stock-compensation expense  | 657                         | 665              |
| Increase in value of bank-owned life insurance                                    | (1,462 )                    | (1,503 )         |
| Proceeds from bank-owned life insurance   | -                           | 14               |
| Change in accrued interest receivable   | 454                         | (440 )           |
| Change in other assets  | 545                         | 3,051            |
| Change in other liabilities   | (1,647 )                    | 3,222            |
| <b>Net Cash Provided by Operating Activities</b>                                  | <b>23,249</b>               | <b>25,410</b>    |
| <b>Investing Activities</b>   |                             |                  |
| Proceeds from sale of money market and mutual fund securities available-for-sale  | -                           | 471,831          |
| Purchases of money market and mutual fund securities available-for-sale           | -                           | (525,502 )       |
| Proceeds from sales of securities available-for-sale                              | 15,642                      | 56,101           |
| Proceeds from maturities and calls of securities available-for-sale               | 51,167                      | 64,844           |
| Proceeds from maturities and calls of securities held-to-maturity                 | 4,158                       | -                |
| Purchases of securities available-for-sale  | (66,560 )                   | (74,287 )        |
| Net (increase) in loans   | (23,152 )                   | (34,123 )        |
| Purchases of premises and equipment   | (4,944 )                    | (2,149 )         |
| Acquisition of Virginia Savings Bancorp, net of cash acquired of \$25,060         | 20,389                      | -                |
| <b>Net Cash Used in Investing Activities</b>                                      | <b>(3,300 )</b>             | <b>(43,285 )</b> |
| <b>Financing Activities</b>   |                             |                  |
| Net increase in noninterest-bearing deposits                                      | 40,841                      | 15,568           |
| Net increase in interest-bearing deposits   | 10,580                      | 47,678           |
| Net (decrease) increase in short-term borrowings                                  | (65,976 )                   | 14,489           |
| Purchases of treasury stock   | (7,915 )                    | (15,085 )        |
| Proceeds from exercise of stock options   | 488                         | 153              |
| Dividends paid  | (10,326 )                   | (10,462 )        |
| <b>Net Cash (Used in) Provided by Financing Activities</b>                        | <b>(32,308 )</b>            | <b>52,341</b>    |
| <b>(Decrease) increase in Cash and Cash Equivalents</b>                           | <b>(12,359 )</b>            | <b>34,466</b>    |

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|  |            |            |
|--|------------|------------|
| Cash and cash equivalents at beginning of period | 146,399    | 66,379     |
| Cash and Cash Equivalents at End of Period       | \$ 134,040 | \$ 100,845 |

See notes to consolidated financial statements.

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Notes to Consolidated Financial Statements (Unaudited)  
June 30, 2012

Note A – Basis of Presentation

The accompanying consolidated financial statements, which are unaudited, include all of the accounts of City Holding Company (“the Parent Company”) and its wholly-owned subsidiaries (collectively, “the Company”). All material intercompany transactions have been eliminated. The consolidated financial statements include all adjustments that, in the opinion of management, are necessary for a fair presentation of the results of operations and financial condition for each of the periods presented. Such adjustments are of a normal recurring nature. The results of operations for the six months ended June 30, 2012 are not necessarily indicative of the results of operations that can be expected for the year ending December 31, 2012. 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, 2011 has been derived from audited financial statements included in the Company’s 2011 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 2011 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 May 2011, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2011-04, “Amendments to Achieve Common Fair Value Measurements and Disclosure Requirements in U.S. GAAP and IFRSs.” This ASU amends Topic 820, “Fair Value Measurements and Disclosures,” to converge the fair value measurement guidance contained in U.S. generally accepted accounting principles and International Financial Reporting Standards (“IFRS”). The provisions of ASU No. 2011-04 clarify existing fair value measurements, amend certain principles set forth in Topic 820 and requires additional fair value disclosures. ASU No. 2011-04 become effective for the Company’s reporting period that began on January 1, 2012. The adoption of ASU No. 2011-04 did not have a material impact on the Company’s financial statements.

In June 2011, the FASB issued ASU No. 2011-05, “Comprehensive Income (Topic 220) – Presentation of Comprehensive Income.” ASU 2011-05 amends Topic 220, “Comprehensive Income,” to require that all non-owner changes in shareholders’ equity be presented in either a single continuous statement of comprehensive income or in two separate, but consecutive statements, thus eliminating the option to present components of comprehensive income within the statement of changes in shareholders’ equity. ASU No. 2011-05 is effective for the Company’s reporting period that began on January 1, 2012; however, certain provisions related to the presentation of reclassification adjustments have been deferred by ASU 2011-12, “Comprehensive Income (Topic 220) – Deferral of the Effective Date for Amendments to the Presentation of Reclassification Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05,” as further discussed below. The adoption of ASU No. 2011-05 did not have a material impact on the Company’s financial statements.

In September 2011, the FASB issued ASU No. 2011-08, “Intangibles – Goodwill and Other (Topic 350) – Testing Goodwill for Impairment.” Under this ASU, an entity has the option to first assess the qualitative factors to determine

whether it is more likely than not that the fair value of the reporting unit is less than its carrying amount. If an entity determines, as a result of this qualitative assessment, that it is not more than likely that the fair value of the reporting unit is less than its carrying amount, then performing the two-step impairment test is unnecessary. ASU No. 2011-08 is effective for the Company's reporting period that began on January 1, 2012. The adoption of ASU No. 2011-08 did not have a material impact on the Company's financial statements.

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In December 2011, the FASB issued ASU No. 2011-12, “Comprehensive Income (Topic 220) – Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05.” This ASU defers the changes in ASU No. 2011-05 that relate to the presentation of reclassification adjustments. ASU No. 2011-12 allows entities to continue to report reclassifications out of accumulated other comprehensive income consistent with the presentation requirements in effect prior to ASU No. 2011-05. All other requirements in ASU No. 2011-05 are not affected. ASU No. 2011-12 is effective for the Company’s reporting period that began on January 1, 2012. The adoption of ASU No. 2011-12 did not have a material impact on the Company’s financial statements.

## Note C – Acquisitions

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

|                                  | May 31,<br>2012 |
|----------------------------------|-----------------|
| <b>Consideration:</b>            |                 |
| Cash                             | \$ 4,672        |
| Common stock                     | 7,723           |
|                                  | \$ 12,395       |
| <b>Identifiable assets:</b>      |                 |
| Cash and cash equivalents        | \$ 25,060       |
| Investment securities            | 14,082          |
| Loans                            | 73,448          |
| Premises and equipment           | 5,158           |
| Other assets                     | 8,860           |
| Total identifiable assets        | 126,608         |
| <b>Identifiable liabilities:</b> |                 |
| Deposits                         | 122,721         |
| Other liabilities                | 698             |
| Total identifiable liabilities   | 123,419         |
| Net identifiable assets          | 3,189           |
| Goodwill                         | 8,014           |
| Core deposit intangible          | 1,192           |
|                                  | \$ 12,395       |

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

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

(2) ASC Topic 310-30 is used to value loans that have evidence of credit quality deterioration. For these loans, the expected cash flows that exceed the fair value of the loan represent the accretable yield, which is recognized as interest income on a level-yield basis over the expected cash flow periods of the loans.

The non-accretable difference represents the difference between the contractually required principal and interest payments and the cash flows expected to be collected based upon management's estimation. Subsequent decreases in the expected cash flows will require the Company to evaluate the need for additions to the Company's allowance for loan losses. Subsequent increases in the expected cash flows will result in a reversal of the provision for loan losses to the extent of prior charges with a corresponding adjustment to the accretable yield, which will result in the recognition of additional interest income over the remaining lives of the loans. The accretable difference represents the difference between the expected cash flows and the net present value of expected cash flows. This difference is accreted into earnings using the level-yield method over the expected cash flow periods of the loans. In determining the net present value of expected cash flows, management used various discount rates based upon the risk characteristics for each loan type.



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The following table presents the loans acquired in conjunction with the VSB acquisition:

|   | May 31,<br>2012 |
|---|-----------------|
| Contractually required principal and interest                                   | \$ 11,049       |
| Contractual cash flows not expected to be collected (non-accretable difference) | (3,734 )        |
| Expected cash flows   | 7,315           |
| Interest component of expected cash flows (accretable difference)               | (675 )          |
| Estimated fair value of purchased credit impaired loans acquired                | \$ 6,640        |
| <br>  |                 |
| Estimated fair value of performing loans acquired                               | 66,808          |
| Estimated fair value of loans acquired  | \$ 73,448       |

The fair values of non-time deposits approximated their carrying value at the acquisition date. For time deposits, the fair values were estimated based on discounted cash flows, using interest rates that are currently being offered compared to the contractual interest rates. Based on this analysis, management recorded a premium on time deposits acquired of \$2.3 million, which is being amortized over ten years.

The Company believes that the customer relationships with the deposits acquired have an intangible value. In connection with the acquisition, the Company recorded a core deposit intangible asset of \$1.2 million, which represents the value of the relationship that VSB had with their deposit customers. The fair value was estimated based on a discounted cash flow methodology that considered type of deposit, deposit retention and the cost of the deposit base. The core deposit intangible is being amortized over ten years, with an annual charge of less than \$0.2 million per year. The following table presents a rollforward of the Company's intangible assets from the beginning of the year:

|   | Intangible<br>Assets |
|---|----------------------|
| Balance, January 1, 2012  | \$ 1,274             |
| Core deposit intangible acquired in conjunction with the acquisition of VSB | 1,192                |
| Amortization expense  | (208 )               |
| Balance, June 30, 2012  | \$ 2,258             |

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

|  | Goodwill  |
|--|-----------|
| Balance, January 1, 2012                                     | \$ 54,890 |
| Goodwill acquired in conjunction with the acquisition of VSB | 8,014     |
| Balance, June 30, 2012                                       | \$ 62,904 |

On August 2, 2012, the Company entered into a definitive agreement to acquire Community Financial Corporation and its wholly-owned subsidiary, Community Bank ("Community"). Community is a \$500 million bank and operates

nine branches along the I-81 corridor in western Virginia and two branches in Virginia Beach, Virginia. The Company anticipates the transaction will be completed in the first quarter of 2013, depending on regulatory approvals, the approval of Community shareholders and the completion of other customary closing conditions. The total transaction value is expected to be approximately \$25.3 million.

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## Note D –Investments

The aggregate carrying and approximate market values of securities follow. Fair values are based on quoted market prices, where available. If quoted market prices are not available, fair values are based on quoted market prices of comparable financial instruments.

| (In thousands)  | June 30, 2012     |                              |                               |                            | December 31, 2011 |                              |                               |                            |
|---|-------------------|------------------------------|-------------------------------|----------------------------|-------------------|------------------------------|-------------------------------|----------------------------|
|   | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Estimated<br>Fair<br>Value | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Estimated<br>Fair<br>Value |
| Securities<br>available-for-sale:                         |                   |                              |                               |                            |                   |                              |                               |                            |
| U.S. Treasuries<br>and U.S.<br>government<br>agencies     | \$5,332           | \$ 118                       | \$ -                          | \$5,450                    | \$5,868           | \$ 173                       | \$ -                          | \$6,041                    |
| Obligations of<br>states and<br>political<br>subdivisions | 52,197            | 1,755                        | 19                            | 53,933                     | 55,262            | 1,561                        | 21                            | 56,802                     |
| Mortgage-backed<br>securities:                            |                   |                              |                               |                            |                   |                              |                               |                            |
| U.S.<br>government<br>agencies                            | 239,859           | 7,119                        | 24                            | 246,954                    | 220,815           | 6,966                        | 168                           | 227,613                    |
| Private label   | 4,080             | 44                           | 28                            | 4,096                      | 5,117             | 45                           | 6                             | 5,156                      |
| Trust preferred<br>securities                             | 50,668            | 448                          | 3,988                         | 47,128                     | 48,951            | 941                          | 4,735                         | 45,157                     |
| Corporate<br>securities                                   | 14,203            | 162                          | 830                           | 13,535                     | 16,226            | 160                          | 1,988                         | 14,398                     |
| Total Debt<br>Securities                                  | 366,339           | 9,646                        | 4,889                         | 371,096                    | 352,239           | 9,846                        | 6,918                         | 355,167                    |
| Marketable equity<br>securities                           | 4,105             | 231                          | 321                           | 4,015                      | 4,318             | -                            | 465                           | 3,853                      |
| Investment funds  | 1,724             | 56                           | -                             | 1,780                      | 1,724             | 39                           | -                             | 1,763                      |
| Total Securities<br>Available-for-Sale                    | \$372,168         | \$ 9,933                     | \$ 5,210                      | \$376,891                  | \$358,281         | \$ 9,885                     | \$ 7,383                      | \$360,783                  |

| (In thousands)                       | June 30, 2012     |                              |                               |                            | December 31, 2011 |                              |                               |                            |
|--------------------------------------|-------------------|------------------------------|-------------------------------|----------------------------|-------------------|------------------------------|-------------------------------|----------------------------|
|                                      | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Estimated<br>Fair<br>Value | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Estimated<br>Fair<br>Value |
| Securities<br>held-to-maturity       |                   |                              |                               |                            |                   |                              |                               |                            |
| Trust preferred<br>securities        | \$19,319          | \$ 504                       | \$ 196                        | \$ 19,627                  | \$23,458          | \$ 675                       | \$ 710                        | \$ 23,423                  |
| Total Securities<br>Held-to-Maturity | \$19,319          | \$ 504                       | \$ 196                        | \$ 19,627                  | \$23,458          | \$ 675                       | \$ 710                        | \$ 23,423                  |

|                              |          |      |      |           |          |      |      |           |
|------------------------------|----------|------|------|-----------|----------|------|------|-----------|
| Other investment securities: |          |      |      |           |          |      |      |           |
| Non-marketable equity        |          |      |      |           |          |      |      |           |
| Securities                   | \$11,686 | \$ - | \$ - | \$ 11,686 | \$11,934 | \$ - | \$ - | \$ 11,934 |
| Total Other Investment       |          |      |      |           |          |      |      |           |
| Securities                   | \$11,686 | \$ - | \$ - | \$ 11,686 | \$11,934 | \$ - | \$ - | \$ 11,934 |

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) as of June 30, 2012 and December 31, 2011. 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 at June 30, 2012 and December 31, 2011.

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| (In thousands)                                   | Less Than Twelve Months |            | June 30, 2012<br>Twelve Months or Greater |            | Total      |            |
|--|-------------------------|------------|---|------------|------------|------------|
|  | Estimated               | Unrealized | Estimated                                 | Unrealized | Estimated  | Unrealized |
|  | Fair Value              | Loss       | Fair Value                                | Loss       | Fair Value | Loss       |
| Securities available-for-sale:                   |                         |            |   |            |            |            |
| Obligations of states and political subdivisions | \$ 2,522                | \$ 17      | \$ 266                                    | \$ 2       | \$ 2,788   | \$ 19      |
| Mortgage-backed securities:                      |                         |            |   |            |            |            |
| U.S. government agencies                         | 31                      | -          | 3,607                                     | 24         | 3,638      | 24         |
| Private label                                    | 2,606                   | 28         | -   | -          | 2,606      | 28         |
| Trust preferred securities                       | 7,670                   | 115        | 5,430                                     | 3,873      | 13,100     | 3,988      |
| Corporate securities                             | -                       | -          | 5,867                                     | 830        | 5,867      | 830        |
| Marketable equity securities                     | 1,374                   | 321        | -   | -          | 1,374      | 321        |
| Total  | \$ 14,203               | \$ 481     | \$ 15,170                                 | \$ 4,729   | \$ 29,373  | \$ 5,210   |

|                              |        |      |          |        |          |        |
|------------------------------|--------|------|----------|--------|----------|--------|
| Securities held-to-maturity: |        |      |          |        |          |        |
| Trust preferred securities   | \$ 991 | \$ 4 | \$ 3,199 | \$ 192 | \$ 4,190 | \$ 196 |

| (In thousands)                                   | Less Than Twelve Months |            | December 31, 2011<br>Twelve Months or Greater |            | Total      |            |
|--|-------------------------|------------|---|------------|------------|------------|
|  | Estimated               | Unrealized | Estimated                                     | Unrealized | Estimated  | Unrealized |
|  | Fair Value              | Loss       | Fair Value                                    | Loss       | Fair Value | Loss       |
| Securities available-for-sale:                   |                         |            |   |            |            |            |
| Obligations of states and political subdivisions | \$ 992                  | \$ 11      | \$ 394  | \$ 10      | \$ 1,386   | \$ 21      |
| Mortgage-backed securities:                      |                         |            |   |            |            |            |
| US Government agencies                           | -                       | -          | 4,333   | 168        | 4,333      | 168        |
| Private label                                    | 3,236                   | 6          | -   | -          | 3,236      | 6          |
| Trust preferred securities                       | 6,724                   | 520        | 5,402   | 4,215      | 12,126     | 4,735      |
| Corporate securities                             | 1,791                   | 241        | 4,941   | 1,747      | 6,732      | 1,988      |
| Marketable equity securities                     | 3,810                   | 465        | -   | -          | 3,810      | 465        |
| Total  | \$ 16,553               | \$ 1,243   | \$ 15,070                                     | \$ 6,140   | \$ 31,623  | \$ 7,383   |

## Securities

held-to-maturity:

|                            |          |        |          |        |           |        |
|----------------------------|----------|--------|----------|--------|-----------|--------|
| Trust preferred securities | \$ 4,823 | \$ 212 | \$ 8,219 | \$ 498 | \$ 13,042 | \$ 710 |
|----------------------------|----------|--------|----------|--------|-----------|--------|

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

During the first six months of 2012, the Company recorded \$0.3 million in credit-related net investment impairment losses. The charges deemed to be other-than-temporary were related to pooled bank trust preferred securities with a remaining book value of \$3.3 million at June 30, 2012. During 2011, the Company recorded \$1.3 million in credit-related net investment impairment losses. The charges deemed to be other-than-temporary were related to pooled bank trust preferred securities (\$0.4 million credit-related net impairment losses for the full year) with a remaining book value of \$3.4 million at December 31, 2011, and community bank and bank holding company equity positions (\$0.9 million credit-related net impairment losses for the full year) with a remaining book value of \$3.9 million at December 31, 2011. The credit-related net impairment charges related to the pooled bank trust preferred securities were based on the Company's quarterly reviews of its investment securities for indications of losses considered to be other than temporary. Based on management's assessment of the securities the Company owns, the seniority position of the securities within the pools, the level of defaults and deferred payments within the pools, management concluded that credit-related impairment charges of \$0.4 million on the pooled bank trust preferred securities were appropriate for the year ending December 31, 2011. During the year ended December 31, 2011, the Company recognized \$0.9 million of credit-related net impairment charges on the Company's equity positions due to the length of time and extent to which the market value of these securities have been below the Company's cost basis. As a result of these factors, the Company does not expect the market value of these securities to recover in the near future.

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Declines in the fair value of held-to-maturity and available-for-sale securities below their cost that are deemed to be other-than-temporary would be reflected in earnings as realized losses. In estimating other-than-temporary impairment losses, management considers, among other things (i) the length of time and the extent to which the fair value has been less than cost, (ii) the financial condition, capital strength, and near-term (12 months) prospects of the issuer, including any specific events which may influence the operations of the issuer such as changes in technology that may impair the earnings potential of the investment or the discontinuance of a segment of the business that may affect the future earnings potential; (iii) the historical volatility in the market value of the investment and/or the liquidity or illiquidity of the investment; (iv) adverse conditions specifically related to the security, an industry, or a geographic area; or (v) the intent to sell the investment security and if it's more likely than not that the Company will not have to sell the security before recovery of its cost basis. In addition, management also employs a continuous monitoring process in regards to its marketable equity securities, specifically its portfolio of regional community bank holdings. Although the regional community bank stocks that are owned by the Company are publicly traded, the trading activity for these stocks is minimal, with trading volumes of less than 0.1% of each respective company being traded on a daily basis. Another factor influencing the market value of these equity securities is a depressed stock market, particularly in the smaller community bank financial sector. As part of management's review process for these securities, management reviews the financial condition of each respective regional community bank for any indications of financial weakness.

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, 2012, management does not intend to sell an impaired security and it is not more than likely that it will be required to sell the security before the recovery of its amortized cost basis. The unrealized losses on debt securities are primarily the result of interest rate changes, credit spread widening on agency-issued mortgage related securities, general financial market uncertainty and unprecedented market volatility. These conditions will not prohibit the Company from receiving its contractual principal and interest payments on its debt securities. The fair value is expected to recover as the securities approach their maturity date or repricing date. As of June 30, 2012, management believes the unrealized losses detailed in the table above are temporary and no impairment loss has been recognized in the Company's consolidated income statement. Should the impairment of any of these securities become other-than-temporary, the cost basis of the investment will be reduced and the resulting loss recognized in net income in the period of the other-than-temporary impairment is identified, while any noncredit loss will be recognized in other comprehensive income.

At June 30, 2012, the book value of the Company's five pooled trust preferred securities totaled \$7.1 million with an estimated fair value of \$3.3 million. All of these securities are mezzanine tranches. Pooled trust preferred securities represent beneficial interests in securitized financial assets that the Company analyzes within the scope of ASC 320, "Investments-Debt and Equity Securities" and are evaluated quarterly for other-than-temporary-impairment ("OTTI"). Management performs an analysis of OTTI utilizing its internal methodology as described below to estimate expected cash flows to be received in the future. The Company reviews each of its pooled trust preferred securities to determine if an OTTI charge would be recognized in current earnings in accordance with ASC 320, "Investments-Debt and Equity Securities". There is a risk that continued collateral deterioration could cause the Company to recognize additional OTTI charges in earnings in the future.

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





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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 by June 2013. 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, 2012 and for the year ended December 31, 2011. 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.

| (In thousands)               | Debt<br>Securities | Equity<br>Securities | Total    |
|------------------------------|--------------------|----------------------|----------|
| Balance at January 1, 2011   | \$20,893           | \$5,130              | \$26,023 |
| Additions:                   |                    |                      |          |
| Initial credit impairment    | -                  | -                    | -        |
| Additional credit impairment | 355                | 918                  | 1,273    |
| Deductions:                  |                    |                      |          |
| Called                       | (638 )             | -                    | (638 )   |
| Balance December 31, 2011    | 20,610             | 6,048                | 26,658   |
| Additions:                   |                    |                      |          |
| Initial credit impairment    | -                  | -                    | -        |
| Additional credit impairment | 304                | -                    | 304      |
| Deductions:                  |                    |                      |          |
| Sold                         | -                  | (786 )               | (786 )   |
| Balance June 30, 2012        | \$20,914           | \$5,262              | \$26,176 |

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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, 2012:

(Dollars in thousands)

| Deal Name                                | Type Class  | Original Cost | Amortized Cost | Fair Value | Difference (1) | Credit Rating | # of issuers | Currently performing (as a % of original collateral) | Expected deferrals/defaults (as a % of remaining performing collateral) | Excess Subordination as a Percentage of Current Performing Collateral (4) |
|--|-------------|---------------|----------------|------------|----------------|---------------|--------------|--|---|---|
|  |             |               |                |            |                |               |              |  |   |   |
| Pooled trust preferred securities:       |             |               |                |            |                |               |              |  |   |   |
| Other-than-temporarily impaired          |             |               |                |            |                |               |              |  |   |   |
| Available for Sale:                      |             |               |                |            |                |               |              |  |   |   |
| P1                                       | Pooled Mezz | \$ 1,158      | \$ 490         | \$ 222     | \$ (268 )      | Ca            | 14           | 26.1 %   | 17.6 %  | (2) 20.0 %  |
| P2                                       | Pooled Mezz | 3,944         | 1,197          | 776        | (421 )         | Ca            | 13           | 25.9 %   | 22.5 %  | (2) 9.1 %   |
| P3 (5)                                   | Pooled Mezz | 2,962         | 1,419          | 373        | (1,046)        | Caa3          | 24           | 24.5 %   | 21.8 %  | (2) 0.0 %   |
| P4 (6)                                   | Pooled Mezz | 4,060         | 672            | 209        | (463 )         | Ca            | 11           | 24.2 %   | 0.0 %   | (3) 0.0 %   |
| P5                                       | Pooled Mezz | 5,806         | 826            | 335        | (491 )         | Ca            | 14           | 27.5 %   | 21.7 %  | (2) 16.4 %  |
| Held to Maturity:                        |             |               |                |            |                |               |              |  |   |   |
| P6                                       | Pooled Mezz | 2,241         | 315            | 445        | 130            | Ca            | 14           | 26.1 %   | 17.6 %  | (2) 20.0 %  |
| P7                                       | Pooled Mezz | 5,237         | 1,061          | 1,035      | (26 )          | Ca            | 13           | 25.9 %   | 22.5 %  | (2) 9.1 %   |
| Single issuer trust preferred securities |             |               |                |            |                |               |              |  |   |   |
| Available for sale:                      |             |               |                |            |                |               |              |  |   |   |
| S1                                       | Single      | 2,048         | 2,028          | 2,049      | 21             | BB+           | 1            | -  | -   |   |
| S2                                       | Single      | 535           | 509            | 511        | 2              | BB+           | 1            | -  | -   |   |
| S3                                       | Single      | 261           | 235            | 128        | (107 )         | NR            | 1            | -  | -   |   |
| S4                                       | Single      | 3,000         | 3,000          | 3,060      | 60             | B2            | 1            | -  | -   |   |
| S5                                       | Single      | 1,000         | 1,000          | 1,038      | 38             | B2            | 1            | -  | -   |   |
| Held to Maturity:                        |             |               |                |            |                |               |              |  |   |   |
| S6                                       | Single      | 4,000         | 4,000          | 4,000      | -              | NR            | 1            | -  | -   |   |
| S7                                       | Single      | 3,360         | 3,101          | 2,940      | (161 )         | NR            | 1            | -  | -   |   |
| S8                                       | Single      | 3,564         | 3,533          | 3,544      | 11             | NR            | 1            | -  | -   |   |

(1) The differences noted consist of unrealized losses recorded at June 30, 2012 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 by June 2013. If additional underlying issuers cure, this bond could recover at a higher percentage.

- (4) Excess subordination is defined as the additional defaults/deferrals necessary in the next reporting period to deplete the entire credit enhancement (excess interest and over-collateralization) beneath our tranche within each pool to the point that would cause a "break in yield." This amount assumes that all currently performing collateral continues to perform. A break in yield means that our security would not be expected to receive all the contractual cash flows (principal and interest) by maturity. The "percent of current performing collateral" is the ratio of the "excess subordination amount" to current performing collateral—a higher percent means there is more excess subordination to absorb additional defaults/deferrals, and the better our security is protected from loss.
- (5) Other-than-temporary impairment losses of \$11,000 were recognized during the six months ended June 30, 2012. Other-than-temporary impairment losses of \$115,000 were recognized during the year ended December 31, 2011.
- (6) Other-than-temporary impairment losses of \$293,000 were recognized during the six months ended June 30, 2012. Other-than-temporary impairment losses of \$240,000 were recognized during the year ended December 31, 2011.

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The amortized cost and estimated fair value of debt securities at June 30, 2012, by contractual maturity, are shown in the following table. Expected maturities will differ from contractual maturities because the issuers of the securities may have the right to prepay obligations without prepayment penalties. Mortgage-backed securities have been allocated to their respective maturity groupings based on their contractual maturity.

| (In thousands)                         | Cost             | Estimated<br>Fair Value |
|--|------------------|-------------------------|
| <b>Securities Available-for-Sale</b>   |                  |                         |
| Due in one year or less                | \$8,374          | \$8,344                 |
| Due after one year through five years  | 38,693           | 39,656                  |
| Due after five years through ten years | 46,229           | 47,485                  |
| Due after ten years                    | 273,043          | 275,611                 |
|  | <b>\$366,339</b> | <b>\$371,096</b>        |
| <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                    | 19,319           | 19,627                  |
|  | <b>\$19,319</b>  | <b>\$19,627</b>         |

The Company recognized \$0.8 million in gross gains from investment security transactions during the three and six months ended June 30, 2012. The Company recognized \$3.1 million in gross gains from investment security transactions during the three and six months ended June 30, 2011. The specific identification method is used to determine the cost basis of securities sold.

The carrying value of securities pledged to secure public deposits and for other purposes as required or permitted by law approximated \$208 million and \$204 million at June 30, 2012 and December 31, 2011, respectively.

## Note E –Loans

The following summarizes the Company's major classifications for loans:

| ( In thousands)  | June 30,<br>2012   | December<br>31, 2011 |
|--|--------------------|----------------------|
| Residential real estate                                | \$997,016          | \$929,788            |
| Home equity – junior liens (including lines of credit) | 143,400            | 141,797              |
| Commercial and industrial                              | 116,288            | 130,899              |
| Commercial real estate                                 | 768,176            | 732,146              |
| Consumer   | 37,383             | 35,845               |
| DDA overdrafts   | 3,326              | 2,628                |
| Gross loans  | 2,065,589          | 1,973,103            |
| Allowance for loan losses                              | (19,452 )          | (19,409 )            |
| Net loans  | <b>\$2,046,137</b> | <b>\$1,953,694</b>   |

Construction loans of \$11.9 million and \$9.2 million are included within residential real estate loans at June 30, 2012 and December 31, 2011, respectively. Construction loans of \$18.5 million and \$20.2 million are included within commercial real estate loans at June 30, 2012 and December 31, 2011, 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 composition of loans acquired in the VSB acquisition outstanding at June 30, 2012 is as follows:

|  | June 30,<br>2012 |
|--|------------------|
| Residential real estate                                | \$41,942         |
| Home equity – junior liens (including lines of credit) | 3,082            |
| Commercial and industrial                              | 2,531            |
| Commercial real estate                                 | 21,226           |
| Consumer   | 3,198            |
| Gross loans  | \$71,979         |

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## Note F –Allowance For Loan Losses

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

Individual credits are selected throughout the year for detailed loan reviews, which are utilized by management to assess the risk in the portfolio and the adequacy of the allowance. Due to the nature of commercial lending, evaluation of the adequacy of the allowance as it relates to these types of loan types is often based more upon specific credit reviews, with consideration given to the potential impairment of certain credits and historical loss rates, adjusted for economic conditions and other inherent risk factors.

A loan acquired and accounted for under ASC Topic 310-30 is reported as an accruing loan and a performing asset.

The following summarizes the activity in the allowance for loan loss, by portfolio segment, for the six months ended June 30, 2012 and 2011. The following also presents the balance in the allowance for loan loss disaggregated on the basis of the Company's impairment measurement method and the related recorded investment in loans, by portfolio segment, as of June 30, 2012 and December 31, 2011.

| (In thousands)  | Commercial<br>and<br>industrial | Commercial<br>real estate | Residential<br>real estate | Home<br>equity | Consumer | DDA<br>overdrafts | Total     |
|---|---------------------------------|---------------------------|----------------------------|----------------|----------|-------------------|-----------|
| Six months<br>ended<br>June 30, 2012:<br>Allowance for<br>loan loss |                                 |                           |                            |                |          |                   |           |
| <b>B e g i n n i n g</b><br>balance                                 | \$ 590                          | \$ 11,666                 | \$ 3,591                   | \$ 2,773       | \$ 88    | \$ 701            | \$ 19,409 |
| Charge-offs   | (117 )                          | (2,015 )                  | (494 )                     | (856 )         | (95 )    | (710 )            | (4,287 )  |
| Recoveries  | 2                               | 97                        | 7                          | 11             | 64       | 524               | 705       |
| Provision   | 110                             | 1,341                     | 720                        | 1,009          | 171      | 274               | 3,625     |
| <b>E n d i n g</b><br>balance                                       | \$ 585                          | \$ 11,089                 | \$ 3,824                   | \$ 2,937       | \$ 228   | \$ 789            | \$ 19,452 |
| Six months<br>ended<br>June 30, 2011:<br>Allowance for<br>loan loss |                                 |                           |                            |                |          |                   |           |
| <b>B e g i n n i n g</b><br>balance                                 | \$ 1,864                        | \$ 8,488                  | \$ 4,149                   | \$ 2,640       | \$ 95    | \$ 988            | \$ 18,224 |
| Charge-offs   | (75 )                           | (200 )                    | (927 )                     | (405 )         | (58 )    | (826 )            | (2,491 )  |
| Recoveries  | 6                               | 28                        | 18                         | 5              | 49       | 733               | 839       |
| Provision   | (851 )                          | 1,707                     | 1,062                      | 437            | 4        | 13                | 2,372     |
| <b>E n d i n g</b><br>balance                                       | \$ 944                          | \$ 10,023                 | \$ 4,302                   | \$ 2,677       | \$ 90    | \$ 908            | \$ 18,944 |

As of June 30,  
2012:

Allowance for  
loan loss

Evaluated for  
impairment:

|   |        |           |          |          |        |        |           |
|---|--------|-----------|----------|----------|--------|--------|-----------|
| Individually                                    | \$ -   | \$ 1,295  | \$ -     | \$ -     | \$ -   | \$ -   | \$ 1,295  |
| Collectively                                    | 585    | 9,794     | 3,824    | 2,937    | 228    | 789    | 18,157    |
| Acquired with<br>deteriorated<br>credit quality | -      | -         | -        | -        | -      | -      | -         |
| Total   | \$ 585 | \$ 11,089 | \$ 3,824 | \$ 2,937 | \$ 228 | \$ 789 | \$ 19,452 |

Loans

Evaluated for  
impairment:

|   |            |            |            |            |           |          |              |
|---|------------|------------|------------|------------|-----------|----------|--------------|
| Individually                                    | \$ -       | \$ 12,640  | \$ 472     | \$ 299     | \$ -      | \$ -     | \$ 13,411    |
| Collectively                                    | 116,288    | 748,896    | 694,046    | 445,599    | 37,383    | 3,326    | 2,045,538    |
| Acquired with<br>deteriorated<br>credit quality | -          | 6,640      | -          | -          | -         | -        | 6,640        |
| Total   | \$ 116,288 | \$ 768,176 | \$ 694,518 | \$ 445,898 | \$ 37,383 | \$ 3,326 | \$ 2,065,589 |

As of  
December 31,  
2011:

Allowance for  
loan loss

Evaluated for  
impairment:

|              |        |           |          |          |       |        |           |
|--------------|--------|-----------|----------|----------|-------|--------|-----------|
| Individually | \$ -   | \$ 2,666  | \$ -     | \$ -     | \$ -  | \$ -   | \$ 2,666  |
| Collectively | 590    | 9,000     | 3,591    | 2,773    | 88    | 701    | 16,743    |
| Total        | \$ 590 | \$ 11,666 | \$ 3,591 | \$ 2,773 | \$ 88 | \$ 701 | \$ 19,409 |

Loans

Evaluated for  
impairment:

|              |            |            |            |            |           |          |              |
|--------------|------------|------------|------------|------------|-----------|----------|--------------|
| Individually | \$ 81      | \$ 15,311  | \$ 476     | \$ 298     | \$ -      | \$ -     | \$ 16,166    |
| Collectively | 130,818    | 716,835    | 638,109    | 432,702    | 35,845    | 2,628    | 1,956,937    |
| Total        | \$ 130,899 | \$ 732,146 | \$ 638,585 | \$ 433,000 | \$ 35,845 | \$ 2,628 | \$ 1,973,103 |

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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: Exceptional, Good, Acceptable, Pass/Watch, 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  |
|-----------------|--|
| 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.  |
| 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. |
| 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.  |
| 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 presents loans by the Company's credit quality indicators, by class, as of June 30, 2012 and December 31, 2011:

| (In thousands)        | Commercial<br>and<br>industrial | Commercial<br>real estate | Residential<br>real estate | Home<br>equity | Consumer  | DDA<br>overdrafts | Total        |
|-----------------------|---------------------------------|---------------------------|----------------------------|----------------|-----------|-------------------|--------------|
| June 30, 2012:        |                                 |                           |                            |                |           |                   |              |
| Risk Grade            |                                 |                           |                            |                |           |                   |              |
| Exceptional           | \$ 3,364                        | \$ 1,825                  | -                          | -              | -         | -                 | \$ 5,189     |
| Good                  | 6,209                           | 104,033                   | -                          | -              | -         | -                 | 110,242      |
| Acceptable            | 69,666                          | 436,010                   | -                          | -              | -         | -                 | 505,676      |
| Pass/watch            | 34,031                          | 173,810                   | -                          | -              | -         | -                 | 207,841      |
| Special mention       | 1,036                           | 15,337                    | -                          | -              | -         | -                 | 16,373       |
| Substandard           | 1,982                           | 36,933                    | -                          | -              | -         | -                 | 38,915       |
| Doubtful              | -                               | 228                       | -                          | -              | -         | -                 | 228          |
| Total                 | \$ 116,288                      | \$ 768,176                |                            |                |           |                   | 884,464      |
| P a y m e n t         |                                 |                           |                            |                |           |                   |              |
| Activity              |                                 |                           |                            |                |           |                   |              |
| Performing            |                                 |                           | \$ 692,334                 | \$ 444,983     | \$ 37,367 | \$ 3,323          | \$ 1,178,007 |
| Non-performing        |                                 |                           | 2,184                      | 915            | 16        | 3                 | 3,118        |
| Total                 |                                 |                           | \$ 694,518                 | \$ 445,898     | \$ 37,383 | \$ 3,326          | \$ 2,065,589 |
| December 31,<br>2011: |                                 |                           |                            |                |           |                   |              |
| Risk Grade            |                                 |                           |                            |                |           |                   |              |
| Exceptional           | \$ 4,220                        | \$ 42                     | -                          | -              | -         | -                 | \$ 4,262     |
| Good                  | 6,728                           | 107,718                   | -                          | -              | -         | -                 | 114,446      |
| Acceptable            | 93,077                          | 411,721                   | -                          | -              | -         | -                 | 504,798      |
| Pass/watch            | 25,246                          | 161,598                   | -                          | -              | -         | -                 | 186,844      |
| Special mention       | 470                             | 16,802                    | -                          | -              | -         | -                 | 17,272       |
| Substandard           | 1,037                           | 34,265                    | -                          | -              | -         | -                 | 35,302       |
| Doubtful              | 121                             | -                         | -                          | -              | -         | -                 | 121          |
| Total                 | \$ 130,899                      | \$ 732,146                |                            |                |           |                   | 863,045      |
| P a y m e n t         |                                 |                           |                            |                |           |                   |              |
| Activity              |                                 |                           |                            |                |           |                   |              |
| Performing            |                                 |                           | \$ 637,586                 | \$ 431,199     | \$ 35,845 | \$ 2,616          | 1,107,246    |
| Non-performing        |                                 |                           | 999                        | 1,801          | -         | 12                | 2,812        |
| Total                 |                                 |                           | \$ 638,585                 | \$ 433,000     | \$ 35,845 | \$ 2,628          | \$ 1,973,103 |

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## 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 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. Unsecured commercial loans are generally charged off when the loan becomes 120 days past due. Secured commercial loans are generally charged off when the loan becomes 120 days past due and open-end consumer loans are generally charged off when the loan becomes 180 days past due.

The following presents an aging analysis of the Company's accruing and non-accruing loans, by class, as of June 30, 2012 and December 31, 2011:

| (In thousands)               | Commercial<br>and<br>industrial | Commercial<br>real estate | Residential<br>real estate | Home<br>equity | Consumer  | DDA<br>overdrafts | Total        |
|------------------------------|---------------------------------|---------------------------|----------------------------|----------------|-----------|-------------------|--------------|
| June 30, 2012:               |                                 |                           |                            |                |           |                   |              |
| 30 – 59 days<br>past due (1) | \$ 540                          | \$ 3,315                  | \$ 4,247                   | \$ 1,668       | \$ 59     | \$ 352            | \$ 10,181    |
| 60 – 89 days<br>past due (1) | -                               | 1,183                     | 1,222                      | 166            | 15        | 9                 | 2,595        |
| Over 90 days<br>past due (1) | -                               | 1,627                     | 106                        | 30             | 16        | 3                 | 1,782        |
| Non-accrual                  | 341                             | 18,422                    | 2,078                      | 885            | -         | -                 | 21,726       |
|                              | 881                             | 24,547                    | 7,653                      | 2,749          | 90        | 364               | 36,284       |
| Current                      | 115,407                         | 743,629                   | 686,865                    | 443,149        | 37,293    | 2,962             | 2,029,305    |
| Total                        | \$ 116,288                      | \$ 768,176                | \$ 694,518                 | \$ 445,898     | \$ 37,383 | \$ 3,326          | \$ 2,065,589 |
| December 31,<br>2011:        |                                 |                           |                            |                |           |                   |              |
|                              | \$ 1,243                        | \$ 576                    | \$ 4,912                   | \$ 1,906       | \$ 133    | \$ 883            | \$ 9,653     |

|                          |            |            |            |            |           |          |              |
|--------------------------|------------|------------|------------|------------|-----------|----------|--------------|
| 30 – 59 days<br>past due |            |            |            |            |           |          |              |
| 60 – 89 days<br>past due | -          | 2,839      | 408        | 228        | 5         | 14       | 3,494        |
| Over 90 days<br>past due | -          | -          | 42         | 112        | -         | 12       | 166          |
| Non-accrual              | 375        | 18,930     | 957        | 1,689      | -         | -        | 21,951       |
|                          | 1,618      | 22,345     | 6,319      | 3,935      | 138       | 909      | 35,264       |
| Current                  | 129,281    | 709,801    | 632,266    | 429,065    | 35,707    | 1,719    | 1,937,839    |
| Total                    | \$ 130,899 | \$ 732,146 | \$ 638,585 | \$ 433,000 | \$ 35,845 | \$ 2,628 | \$ 1,973,103 |

- (1) A loan acquired and accounted for under ASC Topic 310-30, in which the Company can reasonably estimate the cash flows of the loan, is reported as an accruing loan and a performing asset. Included in the 30-59 day, 60-89 day and over 90 day categories above are \$0.2 million, \$1.1 million and \$1.6 million, respectively, of such loans at June 30, 2012.

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## Impaired Loans

The following presents the Company's impaired loans, by class, as of June 30, 2012 and December 31, 2011:

| (In thousands)                     | Commercial<br>and<br>industrial | Commercial<br>real estate | Residential<br>real estate | Home<br>equity | Consumer | DDA<br>overdrafts | Total     |
|------------------------------------|---------------------------------|---------------------------|----------------------------|----------------|----------|-------------------|-----------|
| June 30, 2012:                     |                                 |                           |                            |                |          |                   |           |
| With no related allowance recorded |                                 |                           |                            |                |          |                   |           |
| Recorded investment                | \$ -                            | \$ 2,791                  | \$ -                       | \$ -           | \$ -     | \$ -              | \$ 2,791  |
| Unpaid principal balance           | -                               | 6,986                     | -                          | -              | -        | -                 | 6,986     |
| With an allowance recorded         |                                 |                           |                            |                |          |                   |           |
| Recorded investment                | \$ 340                          | \$ 15,632                 | \$ 2,184                   | \$ 916         | \$ 10    | \$ 2              | \$ 19,084 |
| Unpaid principal balance           | 340                             | 15,632                    | 2,184                      | 916            | 10       | 2                 | 19,084    |
| Related allowance                  | 42                              | 1,921                     | 270                        | 113            | 1        | 2                 | 2,349     |
| December 31, 2011:                 |                                 |                           |                            |                |          |                   |           |
| With no related allowance recorded |                                 |                           |                            |                |          |                   |           |
| Recorded investment                | \$ 78                           | \$ 2,840                  | \$ -                       | \$ -           | \$ -     | \$ -              | \$ 2,918  |
| Unpaid principal balance           | 78                              | 6,036                     | -                          | -              | -        | -                 | 6,114     |
| With an allowance recorded         |                                 |                           |                            |                |          |                   |           |
| Recorded investment                | \$ 297                          | \$ 16,090                 | \$ 1,000                   | \$ 1,801       | \$ -     | \$ 12             | \$ 19,200 |
| Unpaid principal                   |                                 |                           |                            |                |          |                   |           |

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|                   |     |        |       |       |   |    |        |
|-------------------|-----|--------|-------|-------|---|----|--------|
| balance           | 297 | 16,090 | 1,000 | 1,801 | - | 12 | 19,200 |
| Related allowance | 53  | 3,044  | 139   | 240   | - | 12 | 3,488  |

The following table presents information related to the average recorded investment and interest income recognized on the Company's impaired loans, by class, for the six months ended June 30, 2012 and 2011:

| (In thousands)                     | Commercial and industrial | Commercial real estate | Residential real estate | Home equity | Consumer | DDA overdrafts | Total     |
|------------------------------------|---------------------------|------------------------|-------------------------|-------------|----------|----------------|-----------|
| June 30, 2012:                     |                           |                        |                         |             |          |                |           |
| With no related allowance recorded |                           |                        |                         |             |          |                |           |
| Average recorded investment        | \$ -                      | \$ 4,337               | \$ -                    | \$ -        | \$ -     | \$ -           | \$ 4,337  |
| Interest income recognized         | -                         | 85                     | -                       | -           | -        | -              | 85        |
| With an allowance recorded         |                           |                        |                         |             |          |                |           |
| Average recorded investment        | \$ 184                    | \$ 14,409              | \$ 936                  | \$ 1,657    | \$ -     | \$ -           | \$ 17,186 |
| Interest income recognized         | 5                         | 298                    | 22                      | 20          | -        | -              | 345       |
| June 30, 2011:                     |                           |                        |                         |             |          |                |           |
| With no related allowance recorded |                           |                        |                         |             |          |                |           |
| Average recorded investment        | \$ -                      | \$ 12,047              | \$ 479                  | \$ 1,047    | \$ -     | \$ -           | \$ 13,573 |
| Interest income recognized         | -                         | 206                    | 15                      | 5           | -        | -              | 226       |
| With an allowance recorded         |                           |                        |                         |             |          |                |           |
| Average recorded investment        | \$ 129                    | \$ 17,166              | \$ 700                  | \$ 314      | \$ -     | \$ -           | \$ 18,309 |
| Interest income recognized         | -                         | 157                    | -                       | -           | -        | -              | 157       |

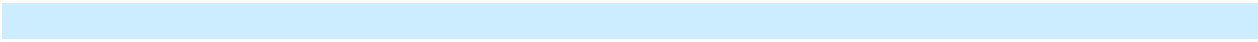


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Approximately \$0.4 million and \$0.1 million of interest income would have been recognized during the six months ended June 30, 2012 and 2011, if such loans had been current in accordance with their original terms. There were no commitments to provide additional funds on non-accrual, impaired or other potential problem loans at June 30, 2012.

## 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 2011-02, 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.

At June 30, 2012, the Company's TDRs totaled less than \$0.4 million. There was no material difference between the pre-modification and post-modification balances. The impact on the allowance for loan losses was insignificant. There were no TDRs that defaulted during the three or six months ended June 30, 2012.

## Note G – Previously Securitized Loans

Between 1997 and 1999, the Company completed six securitization transactions involving approximately \$760 million in 125% of fixed rate, junior-lien underlying mortgages. The Company retained a financial interest in each of the securitizations until 2004. Principal amounts owed to investors were evidenced by securities ("Notes"). During 2003 and 2004, the Company exercised its early redemption options on each of those securitizations. Once the Notes were redeemed, the Company became the beneficial owner of the mortgage loans and recorded the loans as assets of the Company within the loan portfolio.

As the Company redeemed the outstanding Notes, no gain or loss was recognized in the Company's financial statements and the remaining mortgage loans were recorded in the Company's loan portfolio as "previously securitized loans," at the lower of carrying value or fair value. Because the carrying value of the mortgage loans incorporated assumptions for expected prepayment and default rates, the carrying value of the loans was generally less than the actual outstanding contractual balance of the loans. As of June 30, 2012, there is no carrying value remaining on these loans, while the actual contractual balances of these loans was \$8.8 million. During the three and six months ended June 30, 2012 and 2011, the Company recognized \$0.7 million and \$1.6 million and \$0.8 million and \$1.7 million, respectively, of interest income from its previously securitized loans.

## Note H – Long-Term Debt

The components of long-term debt are summarized below:

| ( In thousands)  | June 30, 2012 | December 31, 2011 |
|--|---------------|-------------------|
| Junior subordinated debentures owed to City Holding Capital Trust III, due 2038, interest at a rate of 3.97% and 3.85%, respectively | \$ 16,495     | \$ 16,495         |



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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, at declining redemption prices ranging from 103.525% to 100.000% on June 15, 2013, and thereafter, 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 costs, 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 I – Derivative Instruments

As of June 30, 2012 and December 31, 2011, 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 at June 30, 2012 and December 31, 2011:

|                   | June 30,<br>2012 | December<br>31,<br>2011 |
|-------------------|------------------|-------------------------|
| Fair Value:       |                  |                         |
| Other Assets      | \$ 14,073        | \$ 11,541               |
| Other Liabilities | 14,073           | 11,541                  |

The following table summarizes the change in fair value of these derivative instruments for the three and six months ended June 30, 2012 and 2011:

|                       | Three Months Ended<br>June 30, |      | Six Months Ended<br>June 30, |      |
|-----------------------|--------------------------------|------|------------------------------|------|
|                       | 2012                           | 2011 | 2012                         | 2011 |
| Change in Fair Value: |                                |      |                              |      |
| Other income          | \$ -                           | \$ - | \$ -                         | \$ - |

Note J – Employee Benefit Plans

During 2003, shareholders approved the City Holding Company 2003 Incentive Plan (“the Plan”). Employees, directors and individuals who provide service to the Company (collectively, “Plan Participants”) are eligible to participate in the Plan. Pursuant to terms of the Plan, 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 Plan Participants. A

maximum of 1,000,000 shares of the Company's common stock may be issued upon the exercise of stock options, SARs and stock awards, but no more than 350,000 shares of common stock may be issued as 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 ten years from the date granted and all options and SARs are exercisable for the period specified in the individual agreement.

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.

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## Stock Options

A summary of the Company's stock option activity and related information is presented below for the six months ended June 30, 2012 and 2011:

|                          | Options   | 2012<br>Weighted-Average<br>Exercise Price | Options  | 2011<br>Weighted-Average<br>Exercise Price |
|--------------------------|-----------|--|----------|--|
| Outstanding at January 1 | 293,817   | \$ 33.95                                   | 287,393  | \$ 33.64                                   |
| Granted                  | 16,876    | 35.39                                      | 16,000   | 35.09                                      |
| Exercised                | (16,899 ) | 28.87                                      | (5,476 ) | 28.00                                      |
| Forfeited                | (1,500 )  | 34.73                                      | -        | -  |
| Outstanding at June 30   | 292,294   | \$ 34.32                                   | 297,917  | \$ 33.83                                   |

Additional information regarding stock options outstanding and exercisable at June 30, 2012, is provided in the following table:

| Ranges of Exercise Prices | No. of Options Outstanding | Weighted-Average Exercise Price | Weighted-Average Contractual Life (Months) | Aggregate Intrinsic Value (in thousands) | No. of Options Currently Exercisable | Weighted-Average Exercise Price of Options Currently Exercisable | Weighted-Average Contractual Life (Months) | Options Currently Exercisable (in thousands) | Aggregate Intrinsic Value of Options |
|---------------------------|----------------------------|---------------------------------|--|--|--------------------------------------|--|--|--|--------------------------------------|
| 26.62 - \$33.90           | 167,918                    | \$ 31.82                        | 45   | \$ 318                                   | 116,584                              | \$ 32.57   | 29   | \$ 135                                       |                                      |
| 35.09 - \$40.88           | 124,376                    | 37.70                           | 68   | -  | 69,000                               | 38.11  | 49   | -  |                                      |
|                           | 292,294                    | \$ 34.32                        | 55   | \$ 318                                   | 185,584                              | 34.63  | 36   | \$ 135                                       |                                      |

Proceeds from stock option exercises were \$0.5 million and less than \$0.2 million during the six months ended June 30, 2012 and 2011, 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, 2012 and 2011 all shares issued in connection with stock option exercises and restricted stock awards were issued from available treasury stock.

The total intrinsic value of stock options exercised was less than \$0.2 million and \$0.1 million during the six months ended June 30, 2012 and 2011, respectively.

Stock-based compensation expense was approximately \$0.1 million for both the six months ended June 30, 2012 and 2011. Unrecognized stock-based compensation expense related to stock options approximated \$0.5 million at June 30, 2012. At such date, the weighted-average period over which this unrecognized expense was expected to be recognized was 1.7 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 during the six months ended June 30:

|                         | 2012  |       | 2011  |       |
|-------------------------|-------|-------|-------|-------|
| Risk-free interest rate | 2.51  | %     | 3.07  | %     |
| Expected dividend yield | 3.90  | %     | 3.88  | %     |
| Volatility factor       | 48.40 | %     | 41.12 | %     |
| Expected life of option | 5.0   | 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.

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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 \$0.3 million and \$0.3 million for the six months ended June 30, 2012 and 2011, respectively. Unrecognized stock-based compensation expense related to non-vested restricted shares was \$2.7 million at June 30, 2012. At June 30, 2012, this unrecognized expense is expected to be recognized over 5.0 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 for the six months ended June 30:

|                          | 2012              |                               | 2011              |                               |
|--------------------------|-------------------|-------------------------------|-------------------|-------------------------------|
|                          | Restricted Awards | Average Market Price at Grant | Restricted Awards | Average Market Price at Grant |
| Outstanding at January 1 | 108,209           |                               | 96,060            |                               |
| Granted                  | 23,336            | \$34.94                       | 14,050            | \$35.07                       |
| Forfeited/Vested         | (12,900 )         |                               | (1,318 )          |                               |
| Outstanding at June 30   | 118,645           |                               | 108,792           |                               |

## 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). Any employee who has attained age 21 is eligible to participate beginning the first day of the month following employment. Unless specifically chosen otherwise, every employee is automatically enrolled in the 401(k) Plan and may make before-tax contributions of between 1% and 15% of eligible pay up to the dollar limit imposed by Internal Revenue Service regulations. The first 6% of an employee's contribution is matched 50% by the Company. The employer matching contribution is invested according to the investment elections chosen by the employee. Employees are 100% vested in both employee and employer contributions and the earnings they generate. The Company's total expense associated with the retirement benefit plan approximated \$0.3 million for both the six months ended June 30, 2012 and June 30, 2011.

The Company also maintains a defined benefit pension plan ("the Defined Benefit Plan") that covers approximately 300 current and former employees. The Defined Benefit Plan was frozen in 1999 subsequent to the Company's acquisition of the plan sponsor. The Defined Benefit Plan maintains a December 31 year-end for purposes of computing its benefit obligations. The Company made contributions of approximately \$0.2 million and \$0.1 million to the Defined Benefit Plan during the six months ended June 30, 2012 and June 30, 2011, respectively.

The following table presents the components of the net periodic pension cost of the Defined Benefit Plan:

| (In thousands) | Three months ended June 30 |      | Six months ended June 30 |      |
|----------------|----------------------------|------|--------------------------|------|
|                | 2012                       | 2011 | 2012                     | 2011 |
|                |                            |      |                          |      |

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Components of net periodic cost:

|                                |        |        |        |        |
|--------------------------------|--------|--------|--------|--------|
| Interest cost                  | \$ 159 | \$ 162 | \$ 318 | \$ 324 |
| Expected return on plan assets | (202 ) | (203 ) | (404 ) | (406 ) |
| Net amortization and deferral  | 174    | 137    | 348    | 274    |
| Net Periodic Pension Cost      | \$ 131 | \$ 96  | \$ 262 | \$ 192 |

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## Note K – 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,<br>2012 | December<br>31, 2011 |
|-------------------------------|------------------|----------------------|
| Commitments to extend credit: |                  |                      |
| Home equity lines             | \$158,774        | \$143,856            |
| Commercial real estate        | 23,933           | 29,995               |
| Other commitments             | 158,724          | 185,602              |
| Standby letters of credit     | 19,775           | 20,110               |
| Commercial letters of credit  | 404              | 412                  |

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.

City National Bank is currently in a civil action pending in the Circuit Court of Kanawha County, West Virginia, in a case styled Thomas Casto v. City National Bank, N.A ("Casto"). This putative class action asserts that the plaintiffs, and others similarly situated, were wrongfully assessed overdraft fees in connection with City National Bank accounts. The plaintiffs alleged that City National Bank's policy of posting debit and check transactions from high to low order was in violation of the West Virginia Consumer Credit and Protection Act, constituted a breach of the implied covenant of good faith and fair dealing and created an unjust enrichment to City National Bank.

In February 2012, City National Bank and the plaintiffs' attorneys in the Casto case submitted an Amended Preliminary Motion to Approve Settlement to the Kanawha County Circuit Court. This motion asked the Court to approve a settlement in which City National Bank will pay the eligible members of the class a total of \$3.366 million and will forgive and release \$3.5 million in account balances of accounts of former customers who are no longer customers of the bank, but left overdrawn accounts. The amounts were increased from the initial Preliminary Motion for Approval due to a systems error in harvesting information regarding City National Bank's customers. The Court has approved the settlement and the Company anticipates that the case will be closed by the end of 2012. At December 31, 2011, the Company had accrued for this probable loss. During the first quarter of 2012, the Company deposited the funds into a qualified settlement fund.

In addition, 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 L – Total Comprehensive Income

The following table sets forth the computation of total comprehensive income:

| (In thousands)   | Three months ended June 30, |          | Six months ended June 30, |           |
|--|-----------------------------|----------|---------------------------|-----------|
|  | 2012                        | 2011     | 2012                      | 2011      |
| Net income   | \$ 7,413                    | \$ 9,830 | \$ 17,442                 | \$ 19,445 |
| Other comprehensive income:                                  |                             |          |                           |           |
| Unrealized security (gains)/losses arising during the period | (659 )                      | 3,395    | 2,791                     | 4,671     |
| Reclassification adjustment for gains included in income     | (528 )                      | (3,128 ) | (497 )                    | (3,128 )  |
|  | (1,187 )                    | 267      | 2,294                     | 1,543     |
| Unrealized loss on interest rate floors                      | -                           | (160 )   | -                         | (477 )    |
| Other comprehensive income before income taxes               | (1,187 )                    | 107      | 2,294                     | 1,066     |
| Tax effect   | 447                         | (40 )    | (864 )                    | (407 )    |
| Other comprehensive income                                   | (740 )                      | 67       | 1,430                     | 659       |
| Total comprehensive income                                   | \$ 6,673                    | \$ 9,897 | \$ 18,872                 | \$ 20,104 |

## Note M – 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 2012 | 2011    | Six months ended June 30 2012 | 2011     |
|--|---------------------------------|---------|-------------------------------|----------|
| Distributed earnings allocated to common stock   | \$5,146                         | \$5,092 | \$10,291                      | \$10,184 |
| Undistributed earnings allocated to common stock | 2,208                           | 4,669   | 7,011                         | 9,123    |
| Net earnings allocated to common shareholders    | \$7,354                         | \$9,761 | \$17,302                      | \$19,307 |
| Average shares outstanding                       | 14,680                          | 15,120  | 14,676                        | 15,244   |
| Effect of dilutive securities:                   |                                 |         |                               |          |
| Employee stock options                           | 79                              | 73      | 84                            | 78       |
| Shares for diluted earnings per share            | 14,759                          | 15,193  | 14,760                        | 15,322   |
| Basic earnings per share                         | \$0.50                          | \$0.65  | \$1.18                        | \$1.27   |
| Diluted earnings per share                       | \$0.50                          | \$0.64  | \$1.17                        | \$1.26   |

Options to purchase approximately 208,900 and 133,000 shares of common stock at an exercise price between \$32.93 and \$40.88 and between \$33.54 and \$40.88 per share were outstanding during the second quarter of 2012 and the second quarter of 2011, respectively, 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.

Note N –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.

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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.

### 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.

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, 2012. 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.

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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 as of June 30, 2012 and December 31, 2011:

| (in thousands)                                   | Total    | Level 1 | Level 2  | Level 3 | Total Gains (Losses) |
|--|----------|---------|----------|---------|----------------------|
| June 30, 2012                                    |          |         |          |         |                      |
| Recurring fair value measurements                |          |         |          |         |                      |
| Financial Assets                                 |          |         |          |         |                      |
| U.S. Government agencies                         | \$5,450  | \$-     | \$5,450  | \$-     |                      |
| Obligations of state and political subdivisions  | 53,933   | -       | 53,933   | -       |                      |
| Mortgage-backed securities:                      |          |         |          |         |                      |
| U.S. Government agencies                         | 246,954  | -       | 246,954  | -       |                      |
| Private label                                    | 4,096    | -       | 4,096    | -       |                      |
| Trust preferred securities                       | 47,128   | -       | 45,085   | 2,043   |                      |
| Corporate securities                             | 13,535   | -       | 13,535   | -       |                      |
| Marketable equity securities                     | 4,015    | 4,015   | -        | -       |                      |
| Investment funds                                 | 1,780    | 1,780   | -        | -       |                      |
| Derivative assets                                | 14,073   | -       | 14,073   | -       |                      |
| Financial Liabilities                            |          |         |          |         |                      |
| Derivative liabilities                           | 14,073   | -       | 14,073   | -       |                      |
| Nonrecurring fair value measurements             |          |         |          |         |                      |
| Financial Assets                                 |          |         |          |         |                      |
| Impaired loans                                   | \$21,875 | \$-     | \$21,523 | \$352   | \$244                |
| December 31, 2011                                |          |         |          |         |                      |
| Recurring fair value measurements                |          |         |          |         |                      |
| Financial Assets                                 |          |         |          |         |                      |
| U.S. Government agencies                         | \$6,041  | \$-     | \$6,041  | \$-     |                      |
| Obligations of states and political subdivisions | 56,802   | -       | 56,802   | -       |                      |
| Mortgage-backed securities:                      |          |         |          |         |                      |
| U.S. Government agencies                         | 227,613  | -       | 227,613  | -       |                      |
| Private label                                    | 5,156    | -       | 5,156    | -       |                      |
| Trust preferred securities                       | 45,157   | -       | 43,175   | 1,982   |                      |
| Corporate securities                             | 14,398   | -       | 14,398   | -       |                      |
| Marketable equity securities                     | 3,853    | 3,853   | -        | -       |                      |
| Investment funds                                 | 1,763    | 1,763   | -        | -       |                      |
| Derivative assets                                | 11,541   | -       | 11,541   | -       |                      |
| Financial Liabilities                            |          |         |          |         |                      |
| Derivative liabilities                           | 11,541   | -       | 11,541   | -       |                      |
| Nonrecurring fair value measurements             |          |         |          |         |                      |

|                         |          |     |          |       |         |
|-------------------------|----------|-----|----------|-------|---------|
| <b>Financial Assets</b> |          |     |          |       |         |
| Impaired loans          | \$22,118 | \$- | \$21,743 | \$375 | \$2,701 |

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) for the six months ended June 30, 2012 and 2011:

| (In thousands)                             | Six months Ended June |         |
|--|-----------------------|---------|
|  | 2012                  | 2011    |
| Beginning balance                          | \$1,982               | \$2,504 |
| Impairment losses on investment securities | -                     | -       |
| Included in other comprehensive income     | 61                    | 911     |
| Transfers into Level 3                     | -                     | -       |
| Ending Balance                             | \$2,043               | \$3,415 |

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 by June 2013.

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The table below presents the Company's Level 2 financial assets and liabilities measured on a nonrecurring basis, 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 during the six months ended June 30, 2012 and 2011. During six months ended June 30, 2012 and 2011, the Company had no Level 3 financial assets and liabilities that were measured on a nonrecurring basis.

| (In thousands)                                      | Six months ended June<br>30 |                 |
|---|-----------------------------|-----------------|
|   | 2012<br>Level 2             | 2011<br>Level 2 |
| Carrying value of impaired loans before allocations | \$5,258                     | \$18,077        |
| Specific valuation allowance allocations            | (650 )                      | (3,805 )        |
| Fair value  | \$4,608                     | \$14,272        |

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, 2012 and 2011, collateral discounts ranged from 20% to 30%.

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 during the six months ended June 30, 2012 and 2011.

| (In thousands)   | Six months ended June<br>30, |         |
|--|------------------------------|---------|
|  | 2012                         | 2011    |
| OREO remeasured at initial recognition:                    |                              |         |
| Carrying value of foreclosed assets prior to remeasurement | \$2,358                      | \$3,794 |
| Charge-offs recognized in the allowance for loan losses    | (857 )                       | (759 )  |
| Fair value   | \$1,501                      | \$3,035 |
| OREO remeasured subsequent to initial recognition:         |                              |         |
| Carrying value of foreclosed assets prior to remeasurement | \$1,594                      | \$119   |
| Write-downs included in other non-interest expense         | (596 )                       | (26 )   |
| Fair value   | \$998                        | \$93    |

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:

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**Securities Held to Maturity:** The fair value of securities 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.

**Time deposits:** 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.

**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.

**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 as of June 30, 2012 and December 31, 2011. 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.

| (In thousands)              | Carrying<br>Amount | Fair Value | Level 1 | Level 2 | Level 3   |
|-----------------------------|--------------------|------------|---------|---------|-----------|
| <b>June 30, 2012</b>        |                    |            |         |         |           |
| <b>Assets:</b>              |                    |            |         |         |           |
| Securities held-to-maturity | 19,319             | 19,627     | -       | 19,627  | -         |
| Net loans                   | 2,046,137          | 2,093,704  | -       | -       | 2,093,704 |
| <b>Liabilities:</b>         |                    |            |         |         |           |
| Time deposits               | 931,278            | 945,472    | -       | 945,472 | -         |
| Long-term debt              | 16,495             | 16,459     | -       | 16,459  | -         |
| <b>December 31, 2011</b>    |                    |            |         |         |           |
| <b>Assets:</b>              |                    |            |         |         |           |
| Securities held-to-maturity | 23,458             | 23,423     | -       | 23,423  | -         |
| Net loans                   | 1,953,694          | 1,991,335  | -       | -       | 1,991,335 |
| <b>Liabilities:</b>         |                    |            |         |         |           |
| Time deposits               | 885,596            | 898,972    | -       | 898,972 | -         |
| Long-term debt              | 16,495             | 16,456     | -       | 16,456  | -         |





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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 2011 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 2011 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, and previously securitized 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.

Pages 38 - 42 of this Quarterly Report on Form 10-Q provide 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, 2008 through 2011. The Company and its subsidiaries state income tax returns are open to audit under the statute of limitations for the years ended December 31, 2008 through 2011.

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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. As a result of this review, the Company recognized \$0.3 million of impairment charges during the quarter ended June 30, 2012. 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.

## Financial Summary

## Six Months Ended June 30, 2012 vs. 2011

The Company reported consolidated net income of \$17.4 million, or \$1.17 per diluted common share, for the six months ended June 30, 2012, compared to \$19.4 million, or \$1.26 per diluted common share, for the first six months of 2011. Return on average assets ("ROA") was 1.26% and return on average equity ("ROE") was 10.9% for the first six months of 2012, compared to 1.44% and 12.3%, respectively, for the first six months of 2011. The results for the six months ended June 30, 2012 include \$4.2 million, or \$0.19 diluted per share on an after tax basis, of acquisition and integration expenses related to the acquisition of Virginia Savings Bancorp, Inc. Excluding these acquisition and integration expenses, the Company would have reported net income of \$20.2 million, a return on assets of 1.46% and a return on average equity of 12.7%.

The Company's net interest income for the first six months of 2012 increased \$2.0 million compared to the first six months of 2011 (see Net Interest Income). The Company recorded a provision for loan losses of \$3.6 million for the first six months of 2012 compared to \$2.4 million for the first six months of 2011 (see Allowance and Provision for Loan Losses). As further discussed under the caption Non-Interest Income and Expense, non-interest income decreased \$2.3 million from the six months ended June 30, 2011, to the six months ended June 30, 2012. Non-interest expenses for the six months ended June 30, 2012 increased \$1.5 million from the six months ended June 30, 2011.

## Three Months Ended June 30, 2012 vs. 2011

The Company reported consolidated net income of \$7.4 million, or \$0.50 per diluted common share, for the three months ended June 30, 2012, compared to \$9.8 million, or \$0.64 per diluted common share, for the three months ended June 30, 2011. Return on average assets ("ROA") was 1.06% and return on average equity ("ROE") was 9.2% for the three months ended June 30, 2012 compared to 1.45% and 12.5%, respectively, for the second quarter of 2011. The results of the three months ended June 30, 2012 include \$4.0 million, or \$0.18 diluted per share on an after tax basis, of acquisition and integration expenses related to the acquisition of Virginia Savings Bancorp, Inc. Excluding these acquisition and integration expenses, the Company would have reported net income of \$10.0 million, a return on assets of 1.44% and a return on average equity of 12.5%.

The Company's net interest income for the second quarter of 2012 increased \$1.3 million compared to the second quarter of 2011 (see Net Interest Income). The Company recorded a provision for loan losses of \$1.7 million for the second quarter of 2012 compared to \$1.3 million for the second quarter of 2011 (see Allowance and Provision for Loan Losses). As further discussed under the caption Non-Interest Income and Expense, non-interest income decreased \$2.7 million from the second quarter ended June 30, 2011, to the second quarter ended June 30,

2012. Non-interest expenses for the second quarter ended June 30, 2012 increased \$1.9 million from the second quarter ended June 30, 2011.

Net Interest Income

Six months Ended June 30, 2012 vs. 2011

The Company's tax equivalent net interest income increased \$2.0 million, or 4.2%, from \$45.8 million during the first six months of 2011 to \$47.8 million during the first six months of 2012. This increase is due to a decrease in interest expense that was primarily related to a decline in the average rate paid on interest bearing deposits which declined from 1.23% during the first six months of 2011 to 0.75% during the first six months of 2012. This decline is primarily due to the average interest rate paid on time deposits decreasing 73 basis points to 1.43% for the six months ended June 30, 2012. The Company's reported net interest margin increased from 3.86% for the six months ended June 30, 2011 to 3.94% for the six months ended June 30, 2012.

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Three Months Ended June 30, 2012 vs. 2011

The Company's tax equivalent net interest income increased \$1.3 million, or 5.6%, from \$22.8 million for the second quarter of 2011 to \$24.0 million for the second quarter of 2012. This increase is due to a decrease in interest expense that was primarily related to a decline in the average rate paid on interest bearing deposits which declined from 1.20% for the second quarter of 2011 to 0.71% for the second quarter of 2012. This decline is primarily due to the average interest rate paid on time deposits decreasing 75 basis points to 1.36% for the second quarter of 2012. In addition, the acquisition of Virginia Savings Bancorp, Inc. added \$0.3 million in net interest income for the second quarter of 2012. The Company's reported net interest margin increased from 3.78% for the quarter ended June 30, 2011 to 3.91% for the quarter ended June 30, 2012.

Table One

Average Balance Sheets and Net Interest Income

(In thousands)

|  | 2012                |               | Six months ended June 30, |                     | 2011          |                | Yield/<br>Rate |
|--|---------------------|---------------|---------------------------|---------------------|---------------|----------------|----------------|
|  | Average<br>Balance  | Interest      | Yield/<br>Rate            | Average<br>Balance  | Interest      | Yield/<br>Rate |                |
| <b>Assets</b>                                  |                     |               |                           |                     |               |                |                |
| <b>Loan portfolio(1):</b>                      |                     |               |                           |                     |               |                |                |
| Residential real estate(2)                     | \$ 1,082,038        | \$ 23,731     | 4.41                      | % \$ 1,027,566      | \$ 24,851     | 4.88           | %              |
| Commercial, financial,<br>and agriculture(3)   | 869,782             | 19,326        | 4.47                      | 795,238             | 18,917        | 4.80           |                |
| Installment loans to<br>individuals(4)         | 44,060              | 1,521         | 6.94                      | 45,841              | 1,664         | 7.32           |                |
| Previously securitized<br>loans(5)             | *                   | 1,632         | *                         | 541                 | 1,658         | 618.02         |                |
| <b>Total loans</b>                             | <b>1,995,880</b>    | <b>46,210</b> | <b>4.66</b>               | <b>1,869,186</b>    | <b>47,090</b> | <b>5.08</b>    |                |
| <b>Securities:</b>                             |                     |               |                           |                     |               |                |                |
| Taxable  | 365,233             | 7,907         | 4.35                      | 434,624             | 9,055         | 4.20           |                |
| Tax-exempt(6)                                  | 40,397              | 1,162         | 5.78                      | 49,532              | 1,395         | 5.68           |                |
| <b>Total securities</b>                        | <b>405,630</b>      | <b>9,069</b>  | <b>4.50</b>               | <b>484,156</b>      | <b>10,450</b> | <b>4.35</b>    |                |
| <b>Deposits in depository<br/>institutions</b> |                     |               |                           |                     |               |                |                |
|  | 8,225               | -             | -                         | 7,976               | -             | -              |                |
| <b>Federal funds sold</b>                      | <b>25,837</b>       | <b>23</b>     | <b>0.18</b>               | <b>30,913</b>       | <b>26</b>     | <b>0.17</b>    |                |
| <b>Total interest-earning<br/>assets</b>       | <b>2,435,572</b>    | <b>55,302</b> | <b>4.57</b>               | <b>2,392,231</b>    | <b>57,566</b> | <b>4.85</b>    |                |
| <b>Cash and due from banks</b>                 | <b>73,171</b>       |               |                           | <b>54,653</b>       |               |                |                |
| <b>Bank premises and<br/>equipment</b>         | <b>66,841</b>       |               |                           | <b>64,387</b>       |               |                |                |
| <b>Other assets</b>                            | <b>216,033</b>      |               |                           | <b>203,875</b>      |               |                |                |
| <b>Less: allowance for loan<br/>losses</b>     | <b>(19,452 )</b>    |               |                           | <b>(18,677 )</b>    |               |                |                |
| <b>Total assets</b>                            | <b>\$ 2,772,165</b> |               |                           | <b>\$ 2,696,469</b> |               |                |                |
| <b>Liabilities</b>                             |                     |               |                           |                     |               |                |                |
| <b>Interest-bearing demand<br/>deposits</b>    |                     |               |                           |                     |               |                |                |
|  | \$ 528,714          | \$ 351        | 0.13                      | % \$ 487,553        | \$ 487        | 0.20           | %              |
| Savings deposits                               | 461,705             | 372           | 0.16                      | 409,818             | 530           | 0.26           |                |
| Time deposits                                  | 892,516             | 6,328         | 1.43                      | 956,430             | 10,262        | 2.16           |                |

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|  |             |          |      |             |          |      |
|--|-------------|----------|------|-------------|----------|------|
| Short-term borrowings                      | 117,685     | 150      | 0.26 | 115,690     | 149      | 0.26 |
| Long-term debt                             | 16,495      | 333      | 4.06 | 16,495      | 315      | 3.85 |
| Total interest-bearing liabilities         | 2,017,115   | 7,534    | 0.75 | 1,985,986   | 11,743   | 1.19 |
| Noninterest-bearing demand deposits        | 403,305     |          |      | 374,270     |          |      |
| Other liabilities                          | 32,676      |          |      | 19,494      |          |      |
| Stockholders' equity                       | 319,069     |          |      | 316,719     |          |      |
| Total liabilities and stockholders' equity | \$2,772,165 |          |      | \$2,696,469 |          |      |
| Net interest income                        |             | \$47,768 |      |             | \$45,823 |      |
| Net yield on earning assets                |             |          | 3.94 | %           |          | 3.86 |
|  |             |          |      |             |          | %    |

- (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) Interest income includes \$0 and \$632 from interest rate floors for the six months ended June 30, 2012 and June 30, 2011, respectively.
- (3) Includes the Company's commercial and industrial and commercial real estate loan categories. Interest income includes \$0 and \$488 from interest rate floors for the six months ended June 30, 2012 and June 30, 2011, respectively.
- (4) Includes the Company's consumer and DDA overdrafts loan categories.
- (5) Effective January 1, 2012, there is no carrying value of the Company's previously securities loans.
- (6) 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,<br>2012 vs. 2011 |            |            |
|--|--|------------|------------|
|  | Increase (Decrease)<br>Due to Change In:   |            |            |
|  | Volume                                     | Rate       | Net        |
| <b>Interest-earning assets:</b>        |  |            |            |
| <b>Loan portfolio</b>                  |  |            |            |
| Residential real estate                | \$1,321                                    | \$(2,441 ) | \$(1,120 ) |
| Commercial, financial, and agriculture | 1,778                                      | (1,369 )   | 409        |
| Installment loans to individual        | (65 )                                      | (78 )      | (143 )     |
| Previously securitized loans           | (1,663 )                                   | 1,637      | (26 )      |
| Total loans                            | 1,371                                      | (2,251 )   | (880 )     |
| <b>Securities:</b>                     |  |            |            |
| Taxable                                | (1,450 )                                   | 302        | (1,148 )   |
| Tax-exempt(1)                          | (258 )                                     | 25         | (233 )     |
| Total securities                       | (1,708 )                                   | 327        | (1,381 )   |
| Federal funds sold                     | (4 )                                       | 1          | (3 )       |
| Total interest-earning assets          | \$(341 )                                   | \$(1,923 ) | \$(2,264 ) |
| <b>Interest-bearing liabilities:</b>   |  |            |            |
| Interest-bearing demand deposits       | \$41                                       | \$(177 )   | \$(136 )   |
| Savings deposits                       | 67   | (225 )     | (158 )     |
| Time deposits                          | (688 )                                     | (3,246 )   | (3,934 )   |
| Short-term borrowings                  | 3  | (2 )       | 1          |
| Long-term debt                         | -  | 18         | 18         |
| Total interest-bearing liabilities     | \$(577 )                                   | \$(3,632 ) | \$(4,209 ) |
| Net Interest Income                    | \$236                                      | \$1,709    | \$1,945    |

(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)

|  | Three months ended June 30, |                  |                |                    |                  |                |
|--|-----------------------------|------------------|----------------|--------------------|------------------|----------------|
|  | Average<br>Balance          | 2012<br>Interest | Yield/<br>Rate | Average<br>Balance | 2011<br>Interest | Yield/<br>Rate |
| <b>Assets</b>                                  |                             |                  |                |                    |                  |                |
| <b>Loan portfolio(1):</b>                      |                             |                  |                |                    |                  |                |
| Residential real estate(2)                     | \$1,096,164                 | \$11,904         | 4.37 %         | \$1,031,768        | \$12,307         | 4.78 %         |
| Commercial, financial,<br>and agriculture(3)   | 876,678                     | 9,742            | 4.47           | 797,909            | 9,440            | 4.75           |
| Installment loans to<br>individuals(4)         | 46,439                      | 751              | 6.50           | 46,427             | 852              | 7.36           |
| Previously securitized<br>loans(5)             | *                           | 746              | *              | 426                | 753              | 708.98         |
| <b>Total loans</b>                             | <b>2,019,281</b>            | <b>23,143</b>    | <b>4.61</b>    | <b>1,876,530</b>   | <b>23,352</b>    | <b>4.99</b>    |
| <b>Securities:</b>                             |                             |                  |                |                    |                  |                |
| Taxable  | 378,656                     | 3,943            | 4.19           | 449,006            | 4,513            | 4.03           |
| Tax-exempt(6)                                  | 39,678                      | 566              | 5.74           | 48,351             | 685              | 5.68           |
| <b>Total securities</b>                        | <b>418,334</b>              | <b>4,509</b>     | <b>4.34</b>    | <b>497,357</b>     | <b>5,198</b>     | <b>4.19</b>    |
| <b>Deposits in depository<br/>institutions</b> |                             |                  |                |                    |                  |                |
|  | 8,863                       | -                | -              | 7,298              | -                | -              |
| Federal funds sold                             | 24,212                      | 12               | 0.20           | 35,000             | 13               | 0.15           |
| <b>Total interest-earning<br/>assets</b>       | <b>2,470,690</b>            | <b>27,664</b>    | <b>4.50</b>    | <b>2,416,185</b>   | <b>28,563</b>    | <b>4.74</b>    |
| Cash and due from banks                        | 70,858                      |                  |                | 52,867             |                  |                |
| Bank premises and<br>equipment                 | 68,936                      |                  |                | 64,432             |                  |                |
| Other assets                                   | 215,692                     |                  |                | 203,262            |                  |                |
| Less: allowance for loan<br>losses             | (19,179 )                   |                  |                | (18,797 )          |                  |                |
| <b>Total assets</b>                            | <b>\$2,806,997</b>          |                  |                | <b>\$2,717,949</b> |                  |                |
| <b>Liabilities</b>                             |                             |                  |                |                    |                  |                |
| <b>Interest-bearing demand<br/>deposits</b>    |                             |                  |                |                    |                  |                |
|  | \$533,666                   | \$173            | 0.13 %         | \$489,876          | \$243            | 0.20 %         |
| Savings deposits                               | 474,976                     | 184              | 0.16           | 417,453            | 273              | 0.26           |
| Time deposits                                  | 895,921                     | 3,026            | 1.36           | 960,187            | 5,052            | 2.11           |
| Short-term borrowings                          | 121,424                     | 77               | 0.26           | 120,139            | 77               | 0.26           |
| Long-term debt                                 | 16,495                      | 165              | 4.02           | 16,495             | 158              | 3.84           |
| <b>Total interest-bearing<br/>liabilities</b>  | <b>2,042,482</b>            | <b>3,625</b>     | <b>0.71</b>    | <b>2,004,150</b>   | <b>5,803</b>     | <b>1.16</b>    |
| <b>Noninterest-bearing<br/>demand deposits</b> |                             |                  |                |                    |                  |                |
|  | 413,709                     |                  |                | 379,129            |                  |                |
| Other liabilities                              | 28,921                      |                  |                | 19,707             |                  |                |
| Stockholders' equity                           | 321,885                     |                  |                | 314,963            |                  |                |



|  |             |          |             |          |
|--|-------------|----------|-------------|----------|
| Total liabilities and stockholders' equity | \$2,806,997 |          | \$2,717,949 |          |
| Net interest income                        |             | \$24,039 |             | \$22,760 |
| Net yield on earning assets                |             |          | 3.91 %      | 3.78 %   |

- (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) Interest income includes \$0 and \$154 from interest rate floors for the three months ended June 30, 2012 and June 30, 2011, respectively.
- (3) Includes the Company's commercial and industrial and commercial real estate loan categories. Interest income includes \$0 and \$242 from interest rate floors for the three months ended June 30, 2012 and June 30, 2011, respectively.
- (4) Includes the Company's consumer and DDA overdrafts loan categories.
- (5) Effective January 1, 2012, there is no carrying value of the Company's previously securities loans.
- (6) 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,<br>2012 vs. 2011 |            |            |
|--|--|------------|------------|
|  | Increase (Decrease)<br>Due to Change In:     |            |            |
|  | Volume                                       | Rate       | Net        |
| Interest-earning assets:               |  |            |            |
| Loan portfolio                         |  |            |            |
| Residential real estate                | \$766  | \$(1,169 ) | \$(403 )   |
| Commercial, financial, and agriculture | 929  | (627 )     | 302        |
| Installment loans to individual        | -  | (101 )     | (101 )     |
| Previously securitized loans           | (751 )                                       | 744        | (7 )       |
| Total loans                            | 944  | (1,153 )   | (209 )     |
| Securities:                            |  |            |            |
| Taxable                                | (705 )                                       | 135        | (570 )     |
| Tax-exempt(1)                          | (123 )                                       | 4          | (119 )     |
| Total securities                       | (828 )                                       | 139        | (689 )     |
| Federal funds sold                     | (4 )   | 3          | (1 )       |
| Total interest-earning assets          | \$112  | \$(1,011 ) | \$(899 )   |
| Interest-bearing liabilities:          |  |            |            |
| Interest-bearing demand deposits       |  |            |            |
| Savings deposits                       | 38   | (127 )     | (89 )      |
| Time deposits                          | (337 )                                       | (1,689 )   | (2,026 )   |
| Short-term borrowings                  | 1  | (1 )       | -          |
| Long-term debt                         | -  | 7          | 7          |
| Total interest-bearing liabilities     | \$(276 )                                     | \$(1,902 ) | \$(2,178 ) |
| Net Interest Income                    | \$388  | \$891      | \$1,279    |

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

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## Loans

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

Table five

Loan Portfolio

| (In thousands)   | December         |             |                  |
|--|------------------|-------------|------------------|
|  | June 30,<br>2012 | 31,<br>2011 | June 30,<br>2011 |
| Residential real estate                                | \$997,016        | \$929,788   | \$902,846        |
| Home equity – junior liens (including lines of credit) | 143,400          | 141,797     | 140,024          |
| Commercial and industrial                              | 116,288          | 130,899     | 121,149          |
| Commercial real estate                                 | 768,176          | 732,146     | 693,959          |
| Consumer   | 37,383           | 35,845      | 36,626           |
| DDA overdrafts   | 3,326            | 2,628       | 2,415            |
| Previously securitized loans                           | -                | -           | 325              |
| Total loans  | \$2,065,589      | \$1,973,103 | \$1,897,344      |

Loan balances increased \$92.5 million from December 31, 2011 to June 30, 2012, with the acquisition of VSB contributing \$72.0 million. Residential real estate loans increased \$67.2 million, or 7.2%, from \$929.8 million at December 31, 2011 to \$997.0 million at June 30, 2012, with the acquisition of VSB contributing \$41.9 million. Residential real estate loans primarily consist of: (i) single-family 1, 3, 5 and 10 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 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, 2012, \$11.9 million of the residential real estate loans were for properties under construction.

Junior lien home equity loans increased \$1.6 million during the first six months of 2012 to \$143.4 million at June 30, 2012, with the acquisition of VSB contributing \$3.1 million. 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 increased \$36.1 million, or 4.9%, from \$732.1 million at December 31, 2011 to \$768.2 million at June 30, 2012, with the acquisition of VSB contributing \$21.2 million. At June 30, 2012, \$18.5 million of the commercial real estate loans were for commercial properties under construction. Offsetting the increase in commercial real estate loans was a decrease in commercial and industrial loans ("C&I") of \$14.6 million, to \$116.3 million at June 30, 2012. This decrease was primarily due to: (i) the Company elected to exit from its participation in a C&I loan that, when originated, was a local company, but over time had become a "Shared National Credit" and would have yielded less than 1.50% going forward and (ii) a large C&I customer sold their business and paid off their outstanding loan balance of \$9 million, offset slightly by \$2.5 million in C&I loans acquired in the VSB acquisition.

Consumer loans increased \$1.6 million, or 4.3%, from \$35.8 million at December 31, 2011 to \$37.4 million at June 30, 2012, with the acquisition of VSB contributing \$3.2 million. 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.

#### 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.

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In evaluating the adequacy of the allowance for loan losses, 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 allowance for loan losses 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 \$3.6 million in the first six months of 2012 and \$2.4 million in the first six months of 2011. 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.

The Company had net charge-offs of \$3.6 million and \$1.7 million for the first six months of 2012 and 2011, respectively. Net charge-offs in the first six months of 2012 consisted primarily of net charge-offs on commercial real estate loans of \$2.0 million and home equity loans of \$0.8 million. Charge-offs for commercial real estate loans were primarily related to a specific borrower filing bankruptcy and the related impaired credits that had been appropriately considered in establishing the allowance for loan losses in the prior period. The Company is currently reviewing recovery options based on its collateral position, although no assurances of any such recoveries can be made at this time.

The Company's ratio of non-performing assets to total loans and other real estate owned decreased from 1.52% at December 31, 2011 to 1.47% at June 30, 2012. The Company's ratio of non-performing assets to total loans and other real estate owned is less than 30% of the 5.34% 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 March 31, 2012.

The ALLL at June 30, 2012 was \$19.5 million compared to \$19.4 million at December 31, 2011. Below is a summary of the changes in the components of the ALLL from December 31, 2011 to June 30, 2012.

The allowance allocated to the commercial real estate loan portfolio (see Table Eight) decreased \$0.6 million, or 4.9%, from \$11.7 million at December 31, 2011 to \$11.1 million at June 30, 2012. This decrease was primarily due to a charge-off relating to a specific borrower filing bankruptcy that had previously been considered in establishing the allowance.

The allowance related to the commercial and industrial loan portfolio remained flat at \$0.6 million at June 30, 2012 (see Table Eight).

The allowance allocated to the residential real estate portfolio (see Table Eight) increased \$0.2 million from \$3.6 million at December 31, 2011 to \$3.8 million at June 30, 2012.

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The allowance allocated to the home equity loan portfolio (see Table Eight) increased \$0.1 million from \$2.8 million at December 31, 2011 to \$2.9 million at June 30, 2012.

The allowance allocated to the consumer loan portfolio (see Table Eight) increased \$0.1 million to \$0.2 million at June 30, 2012.

The allowance allocated to overdraft deposit accounts (see Table Eight) increased modestly from \$0.7 million at December 31, 2011 to \$0.8 million at June 30, 2012.

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, 2012, 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 |             | Year                             |
|--|-----------------------|-------------|----------------------------------|
|  | 2012                  | 30,<br>2011 | ended<br>December<br>31,<br>2011 |
| Balance at beginning of period               | \$ 19,409             | \$ 18,224   | \$ 18,224                        |
| <b>Charge-offs:</b>                          |                       |             |                                  |
| Commercial and industrial                    | 117                   | 75          | 522                              |
| Commercial real estate                       | 2,015                 | 200         | 1,989                            |
| Residential real estate                      | 494                   | 927         | 1,367                            |
| Home equity                                  | 856                   | 405         | 1,089                            |
| Consumer                                     | 95                    | 58          | 164                              |
| DDA overdrafts                               | 710                   | 826         | 1,712                            |
| Total charge-offs                            | 4,287                 | 2,491       | 6,843                            |
| <b>Recoveries:</b>                           |                       |             |                                  |
| Commercial and industrial                    | 2                     | 6           | 23                               |
| Commercial real estate                       | 97                    | 28          | 1,981                            |
| Residential real estate                      | 7                     | 18          | 29                               |
| Home equity                                  | 11                    | 5           | 7                                |
| Consumer                                     | 64                    | 49          | 136                              |
| DDA overdrafts                               | 524                   | 733         | 1,252                            |
| Total recoveries                             | 705                   | 839         | 3,428                            |
| Net charge-offs                              | 3,582                 | 1,652       | 3,415                            |
| Provision for loan losses                    | 3,625                 | 2,372       | 4,600                            |
| Balance at end of period                     | \$ 19,452             | \$ 18,944   | \$ 19,409                        |
| <b>As a Percent of Average Total Loans:</b>  |                       |             |                                  |
| Net charge-offs (annualized)                 | (0.36 )%              | (0.18 )%    | 0.18 %                           |
| Provision for loan losses (annualized)       | 0.36 %                | 0.25 %      | 0.24 %                           |
| <b>As a Percent of Non-Performing Loans:</b> |                       |             |                                  |
| Allowance for loan losses                    | 88.92 %               | 81.08 %     | 87.76 %                          |

Table seven  
Non-Accrual, Past-Due and Restructured loans

| (In thousands)    | As of June 30, |           | As of                   |
|-------------------|----------------|-----------|-------------------------|
|                   | 2012           | 2011      | December<br>31,<br>2011 |
| Non-accrual loans | \$ 21,726      | \$ 23,178 | \$ 21,951               |

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|   |          |          |          |
|---|----------|----------|----------|
| Accruing loans past due 90 days or more | 149      | 188      | 166      |
| Total non-performing loans              | 21,875   | 23,366   | 22,117   |
| Total other real estate owned           | 8,697    | 7,999    | 7,948    |
| Total non-performing assets             | \$30,572 | \$31,365 | \$30,065 |

The average recorded investment in impaired loans during the six months ended June 30, 2012 and 2011 was \$21.5 million and \$31.9 million, respectively. The Company recognized approximately \$0.4 million of interest income received in cash on non-accrual and impaired loans for the six month periods ended June 30, 2012 and June 30, 2011, respectively. Approximately \$0.4 million and \$0.1 million of interest income would have been recognized during the six month periods ended June 30, 2012 and June 30, 2011, respectively, 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, 2012 and December 31, 2011. The Company recognized interest income of \$0.4 million using the accrual method of income recognition during the time period the loans were impaired for the six month periods ended June 30, 2012 and June 30, 2011, respectively.

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.



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Information pertaining to impaired loans is included in the following table:

| (In thousands)  | As of June 30, |          | As of<br>December<br>31, |
|---|----------------|----------|--------------------------|
|   | 2012           | 2011     | 2011                     |
| Impaired loans with a valuation allowance             | \$19,084       | \$20,233 | \$19,200                 |
| Impaired loans with no valuation allowance            | 2,791          | 13,574   | 2,918                    |
| Total impaired loans                                  | \$21,875       | \$33,807 | \$22,118                 |
| Allowance for loan losses allocated to impaired loans | \$2,349        | \$4,393  | \$3,488                  |

Table eight  
Allocation of the Allowance For Loan Losses

| (In thousands)            | As of June 30, |          | As of<br>December<br>31, |
|---------------------------|----------------|----------|--------------------------|
|                           | 2012           | 2011     | 2011                     |
| Commercial and industrial | \$585          | \$944    | \$590                    |
| Commercial real estate    | 11,089         | 10,023   | 11,666                   |
| Residential real estate   | 3,824          | 4,302    | 3,591                    |
| Home equity               | 2,937          | 2,677    | 2,773                    |
| Consumer                  | 228            | 90       | 88                       |
| DDA overdrafts            | 789            | 908      | 701                      |
| Allowance for Loan Losses | \$19,452       | \$18,944 | \$19,409                 |

#### Previously Securitized Loans

As of June 30, 2012, there is no carrying value remaining on the previously securitized loans, while the actual contractual balances of these loans were \$8.8 million. The Company accounts for the difference between the carrying value and the total expected cash flows of previously securitized loans as an adjustment of the yield earned on these loans over their remaining lives. The discount was accreted to income over the period during which payments were probable of collection and were reasonably estimable. During the first six months of 2012 and 2011, the Company recognized \$1.6 million and \$1.7 million, respectively, of interest income on its previously securitized loans.

#### Non-Interest Income and Non-Interest Expense

##### Six Months Ended June 30, 2012 vs. 2011

Non-Interest Income: During 2012, the Company sold certain equity positions related to community banks and bank holding companies and realized a \$0.8 million gain. This gain was partially offset by \$0.3 million of credit-related net investment impairment losses recorded by the Company. These charges deemed to be other than temporary were related to pooled bank trust preferred securities with a remaining book value of \$3.3 million at June 30, 2012. The credit-related net impairment charges were based on the Company's quarterly reviews of its investment securities for indications of losses considered to be other than temporary. Exclusive of this net investment gain, non-interest income increased \$0.3 million to \$26.4 million in the first six months of 2012 as compared to \$26.1 million in the first six months of 2011. This increase was primarily the result of trust and investment management fee income increasing \$0.3 million, or 17.9%, to \$1.7 million and insurance commissions increasing \$0.2 million, or 7.0%, to \$3.3 million for the six months ended June 30, 2012. These increases were partially offset by a \$0.2 million decrease in service charges for the six months ended June 30, 2012 compared to the six months ended June 30, 2011.

Non-Interest Expense: During 2012, the Company completed its acquisition of Virginia Savings Bancorp, Inc. and recognized \$4.2 million of acquisition and integration expenses. In comparison, during 2011, the Company recorded a \$3.0 million litigation reserve accrual. Excluding these expenses, non-interest expenses increased \$0.3 million from \$39.8 million in the first six months 2011 to \$40.1 million in the first six months of 2012. This increase was primarily related to increases in salaries and employee benefits of \$0.8 million and repossessed asset losses of \$0.6 million that were partially offset by lower FDIC insurance expense of \$1.1 million due to a change in the assessment base methodology.

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**Income Tax Expense:** The Company's effective income tax rate for the six months ended June 30, 2012 was 33.8% compared to 33.6% for the year ended December 31, 2011, and 33.8% for the six months ended June 30, 2011. The effective rate is based upon the Company's expected tax rate for the year ending December 31, 2012.

Three Months Ended June 30, 2012 vs. 2011

**Non-Interest Income:** Exclusive of the net investment gain discussed above, non-interest income decreased \$0.1 million to \$13.3 million in the second quarter of 2012 as compared to \$13.4 million in the second quarter of 2011. This decrease was primarily the result of service charges decreasing \$0.2 million, or 2.1%, to \$9.6 million and insurance commissions decreasing \$0.2 million, or 10.4%, to \$1.3 million for the quarter ended June 30, 2012. These decreases were partially offset by an increase of \$0.2 million in trust and investment management fee income to \$0.9 million for the quarter ended June 30, 2012 and \$0.1 million due to the acquisition of Virginia Savings Bancorp, Inc.

**Non-Interest Expense:** During the second quarter of 2012, the Company completed its acquisition of Virginia Savings Bancorp, Inc. and recognized \$4.0 million of acquisition and integration expenses. In comparison, the Company recorded a \$3.0 million litigation reserve accrual during the second quarter of 2011. Excluding these expenses, non-interest expenses increased \$0.8 million from \$19.9 million in the second quarter of 2011 to \$20.7 million in the second quarter of 2012. Repossessed asset losses increased \$0.7 million due to the decline in estimated fair value of a foreclosed property located in the eastern panhandle of West Virginia. The Company continually reevaluates the estimated fair value of properties that it has repossessed by obtaining updated appraisals on at least an annual basis. As a result of this write-down, this foreclosed property is now valued at approximately one-half of its original cost. In addition, salaries and employee benefits increased \$0.4 million, other expenses increased \$0.2 million, and the acquisition of Virginia Savings Bancorp, Inc. added \$0.2 million. These increases were partially offset by a decrease of \$0.5 million due to lower FDIC insurance expense as a result of a change in assessment base methodology.

**Income Tax Expense:** The Company's effective income tax rate for the second quarter of 2012 was 33.8% compared to 33.6% for the year ended December 31, 2011, and 33.8% for the second quarter of 2011. The effective rate is based upon the Company's expected tax rate for the year ending December 31, 2012.

## 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.

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.

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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<br>Basis<br>Point<br>Change<br>in Interest<br>Rates | Implied<br>Federal<br>Funds Rate<br>Associated<br>with<br>Change in<br>Interest<br>Rates | Estimated<br>Increase<br>(Decrease)<br>in<br>Net<br>Income<br>Over 12<br>Months | Estimated<br>Increase<br>(Decrease)<br>in<br>Economic<br>Value of<br>Equity |
|---|--|---|---|
| June 30,<br>2012:   |  |   |   |
| +400  | 4.25 %   | +22.2 %   | +19.6 %   |
| +300  | 3.25   | +15.9   | +16.5   |
| +200  | 2.25   | +9.8  | +11.2   |
| +100  | 1.25   | +2.2  | +4.8  |
| December<br>31, 2011:   |  |   |   |
| +400  | 4.25 %   | +16.0 %   | +20.3 %   |
| +300  | 3.25   | +10.4   | +16.4   |
| +200  | 2.25   | +5.6  | +11.2   |
| +100  | 1.25   | +0.8  | +5.1  |

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, 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 2012 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.

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. Dividends paid by City National Bank 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 Bank in the current year plus retained net profits for the preceding two years must be approved by regulatory authorities. At June 30, 2012, City National Bank could pay dividends up to \$19.9 million plus net profits for the remainder of 2012, as defined by statute, up to the dividend declaration date without prior regulatory permission.

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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 \$0.7 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 \$20.7 million on an annualized basis over the next 12 months based on common shareholders of record at June 30, 2012. 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 \$0.6 million of additional cash over the next 12 months. As of June 30, 2012, the Parent Company reported a cash balance of \$3.5 million and management believes that the Parent Company's available cash balance, together with cash dividends from City National Bank 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 2012 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 Bank or the issuance of other debt, to fully repay the debentures at their maturity.

City National Bank 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 Bank 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, 2012, City National Bank's assets are significantly funded by deposits and capital. Additionally, City National Bank 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, 2012, City National Bank has the capacity to borrow an additional \$1 billion from the FHLB and other financial institutions under existing borrowing facilities. City National Bank 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, City National Bank maintains a significant percentage (92.4%, or \$376.9 million at June 30, 2012) of its investment securities portfolio in the highly liquid available-for-sale classification. Although it has no current intention to do so, these securities could be liquidated, if necessary, to provide an additional funding source. City National Bank 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 70.7% as of June 30, 2012 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 significant investment security balances with carrying values that totaled \$407.9 million at June 30, 2012, and that greatly exceeded the Company's non-deposit sources of borrowing which totaled \$139.6 million. Further, the Company's deposit mix has a very high proportion of transaction and savings accounts that fund 50.6% of the Company's total assets.

As illustrated in the Consolidated Statements of Cash Flows, the Company generated \$23.2 million of cash from operating activities during the first six months of 2012, primarily from interest income received on loans and investments, net of interest expense paid on deposits and borrowings. The Company used \$3.3 million of cash in investing activities during the first six months of 2012 primarily for purchases of securities available-for-sale, net of proceeds from these securities and from maturities and calls of securities available-for-sale, partially offset by the acquisition of Virginia Savings Bancorp. The Company used \$32.3 million of cash in financing activities during the

first six months of 2012, principally as a result of decreasing its short-term borrowings by \$66.0 million, cash dividends paid to the Company's common stockholders of \$10.3 million and the purchase of treasury stock of \$7.9 million, partially offset by increasing its interest and noninterest bearing deposits by \$51.4 million.

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## Capital Resources

During the first six months of 2012, Shareholders' Equity increased \$9.5 million, or 3.0%, from \$311.1 million at December 31, 2011 to \$320.6 million at June 30, 2012. This increase was primarily due to net income of \$17.4 million, partially offset by dividends declared of \$10.3 million and common stock purchases of \$7.9 million.

During July 2011, the Board of Directors authorized the Company to buy back up to 1,000,000 shares of its common shares in open market transactions at prices that are accretive to the earnings per share of continuing shareholders. No time limit was placed on the duration of the share repurchase program. Approximately 238,000 shares were repurchased during the first six months of 2012 and there can be no assurance that the Company will continue to reacquire its common shares or to what extent the repurchase program will be successful. As of June 30, 2012, the Company may repurchase an additional 455,000 shares from time to time depending on market conditions under the authorization.

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 | June 30, 2012 | Actual December 31, 2011 |
|---------------------|---------|------------------|---------------|--------------------------|
| City Holding:       |         |                  |               |                          |
| Total               | 8.0 %   | 10.0 %           | 13.4 %        | 14.1 %                   |
| Tier I Risk-based   | 4.0     | 6.0              | 12.5          | 13.1                     |
| Tier I Leverage     | 4.0     | 5.0              | 9.7           | 10.2                     |
| City National Bank: |         |                  |               |                          |
| Total               | 8.0 %   | 10.0 %           | 12.4 %        | 13.0 %                   |
| Tier I Risk-based   | 4.0     | 6.0              | 11.5          | 12.0                     |
| Tier I Leverage     | 4.0     | 5.0              | 9.0           | 9.3                      |

As of June 30, 2012, 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, 2012, management believes that City Holding and City National Bank meet all capital adequacy requirements.

## 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.



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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, 2012 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.

City National Bank is currently in a civil action pending in the Circuit Court of Kanawha County, West Virginia, in a case styled Thomas Casto v. City National Bank, N.A (“Casto”). This putative class action asserts that the plaintiffs, and others similarly situated, were wrongfully assessed overdraft fees in connection with City National Bank accounts. The plaintiffs alleged that City National Bank’s policy of posting debit and check transactions from high to low order was in violation of the West Virginia Consumer Credit and Protection Act, constituted a breach of the implied covenant of good faith and fair dealing and created an unjust enrichment to City National Bank.

In February 2012, City National Bank and the plaintiffs’ attorneys in the Casto case submitted an Amended Preliminary Motion to Approve Settlement to the Kanawha County Circuit Court. This motion asked the Court to approve a settlement in which City National Bank will pay the eligible members of the class a total of \$3.366 million and will forgive and release \$3.5 million in account balances of accounts of former customers who are no longer customers of the bank, but left overdrawn accounts. The amounts were increased from the initial Preliminary Motion for Approval due to a systems error in harvesting information regarding City National Bank’s customers. The Court has approved the settlement and the Company anticipates that the case will be closed by the end of 2012. At December 31, 2011, the Company had accrued for this probable loss. During the first quarter of 2012, the Company deposited the funds into a qualified settlement fund.

In addition, 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, 2011.

## 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<br>Number<br>Of Shares<br>Purchased | Average<br>Price<br>Paid per<br>Share | Total<br>Number<br>of Shares<br>Purchased<br>as Part of<br>Publicly<br>Announced<br>Plans<br>Or Programs<br>(a) | Maximum<br>Number of<br>Shares that<br>May Yet Be<br>Purchased<br>Under the<br>Plans or<br>Programs |
|--------|---|---------------------------------------|---|---|
|--------|---|---------------------------------------|---|---|

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|                          |        |          |        |         |
|--------------------------|--------|----------|--------|---------|
| April 1 – April 30, 2012 | 35,000 | \$ 33.29 | 35,000 | 569,023 |
| May 1 – May 31, 2012     | 35,200 | 32.49    | 35,200 | 533,823 |
| June 1 – June 30, 2012   | 79,335 | 31.94    | 79,335 | 454,488 |

(a) On July 27, 2011, the Company announced that the Board of Directors rescinded the October 2009 share repurchase program and announced that it had authorized the Company to buy back up to 1,000,000 shares of its common stock, in open market transactions, at prices that are accretive to continuing shareholders. No timetable was placed on the duration of this share repurchase program.

|         |                                  |       |
|---------|----------------------------------|-------|
| Item 3. | Defaults Upon Senior Securities. | None. |
| Item 4. | Mine Safety Disclosures          | None. |
| Item 5. | Other Information.               | None. |

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|         |              |  |
|---------|--------------|--|
| Item 6. | Exhibits.    |  |
|         | (a) Exhibits |  |
|         | <u>31(a)</u> | Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 for Charles R. Hageboeck   |
|         | <u>31(b)</u> | Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 for David L. Bumgarner   |
|         | <u>32(a)</u> | 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 |
|         | <u>32(b)</u> | 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.

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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 9, 2012