NBT BANCORP INC
Form 10-Q
November 09, 2012

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549
FORM 10-Q

(Mark One)
x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2012.
OR
o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from ________ to ________.

COMMISSION FILE NUMBER 0-14703

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

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

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

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

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (Section 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No o

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

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

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

As of October 31, 2012, there were 33,745,327 shares outstanding of the Registrant's common stock, $0.01 par value per share.

NBT BANCORP INC.

FORM 10-Q--Quarter Ended September 30, 2012

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Item 1 – FINANCIAL STATEMENTS

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

(In thousands, except share and per share data)	September 30, 2012	December 31, 2011
Assets		
Cash and due from banks	$ 137,747	$ 128,517
Short-term interest bearing accounts	2,693	864
Securities available for sale, at fair value	1,191,107	1,244,619
Securities held to maturity (fair value $62,401 and $72,198, respectively)	61,302	70,811
Trading securities	3,851	3,062
Federal Reserve and Federal Home Loan Bank stock	28,706	27,020
Loans and leases	4,251,119	3,800,203
Less allowance for loan and lease losses	70,734	71,334
Net loans and leases	4,180,385	3,728,869
Premises and equipment, net	77,326	74,541
Goodwill	152,251	132,029
Intangible assets, net	17,346	18,194
Bank owned life insurance	79,854	77,626
Other assets	96,348	92,254
Total assets	$ 6,028,916	$ 5,598,406
Liabilities		
Demand (noninterest bearing)	$ 1,187,502	$ 1,052,906
Savings, NOW, and money market	2,599,556	2,381,116
Time	1,018,957	933,127
Total deposits	4,806,015	4,367,149
Short-term borrowings	137,365	181,592
Long-term debt	367,144	370,344
Trust preferred debentures	75,422	75,422
Other liabilities	66,309	65,789
Total liabilities	5,452,255	5,060,296
Stockholders' equity		
Preferred stock, $0.01 par value. Authorized 2,500,000 shares at September 30, 2012 and December 31, 2011	-	-
Common stock, $0.01 par value. Authorized 100,000,000 shares at September 30, 2012 and 50,000,000 December 31, 2011; issued 39,305,131 at September 30, 2012 and 38,035,539 at December 31, 2011	393	380
Additional paid-in-capital	345,934	317,329
Retained earnings	351,261	329,981
Accumulated other comprehensive loss	(3,746)	(6,104)
Common stock in treasury, at cost, 5,562,454 and 4,878,829 shares at September 30, 2012 and December 31, 2011, respectively	(117,181)	(103,476)
Total stockholders' equity	576,661	538,110
Total liabilities and stockholders' equity	$ 6,028,916	$ 5,598,406

See accompanying notes to unaudited interim consolidated financial statements.

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NBT Bancorp Inc. and Subsidiaries Consolidated Statements of Income (unaudited) (In thousands, except per share data)	Three months ended September 30, 2012	Three months ended September 30, 2011	Nine months ended September 30, 2012	Nine months ended September 30, 2011
Interest, fee, and dividend income				
Interest and fees on loans and leases	$ 53,817	$ 50,991	$ 154,534	$ 152,977
Securities available for sale	6,550	7,771	21,024	23,622
Securities held to maturity	572	680	1,829	2,225
Other	348	342	1,153	1,275
Total interest, fee, and dividend income	61,287	59,784	178,540	180,099
Interest expense				
Deposits	4,544	5,352	14,521	17,690
Short-term borrowings	60	56	149	166
Long-term debt	3,640	3,621	10,801	10,783
Trust preferred debentures	436	394	1,319	1,683
Total interest expense	8,680	9,423	26,790	30,322
Net interest income	52,607	50,361	151,750	149,777
Provision for loan and lease losses	4,755	5,175	13,329	15,161
Net interest income after provision for loan and lease losses	47,852	45,186	138,421	134,616
Noninterest income				
Insurance and other financial services revenue	5,591	5,127	17,024	15,925
Service charges on deposit accounts	4,626	5,532	13,538	16,059
ATM and debit card fees	3,378	3,135	9,403	8,731
Retirement plan administration fees	2,718	2,295	7,462	6,734
Trust	2,242	2,090	6,683	6,384
Bank owned life insurance	639	674	2,228	2,369
Net securities gains	26	12	578	98
Other	2,407	1,329	8,449	3,881
Total noninterest income	21,627	20,194	65,365	60,181
Noninterest expense				
Salaries and employee benefits	26,641	25,068	78,358	74,107
Occupancy	4,437	3,887	13,150	12,396
Data processing and communications	3,352	3,054	10,041	9,085
Professional fees and outside services	2,735	2,215	7,848	6,369
Equipment	2,435	2,288	7,224	6,658
Office supplies and postage	1,597	1,531	4,842	4,418
FDIC expenses	939	920	2,812	3,381
Advertising	701	685	2,308	2,286
Amortization of intangible assets	870	782	2,530	2,286
Loan collection and other real estate owned	614	676	2,051	1,838
Merger expenses	558	155	1,895	155
Other	4,552	3,785	12,236	10,285
Total noninterest expense	49,431	45,046	145,295	133,264
Income before income tax expense	20,048	20,334	58,491	61,533
Income tax expense	5,513	5,117	17,049	17,354
Net income	$ 14,535	$ 15,217	$ 41,442	$ 44,179
Earnings per share				
Basic	$ 0.43	$ 0.46	$ 1.24	$ 1.30

Diluted	$ 0.43	$ 0.45	$ 1.23	$ 1.29

See accompanying notes to unaudited interim consolidated financial statements.

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Consolidated Statements of Comprehensive Income (unaudited) (In thousands)	Three months ended September 30, 2012	Three months ended September 30, 2011	Nine months ended September 30, 2012	Nine months ended September 30, 2011
Net income	$ 14,535	$ 15,217	$ 41,442	$ 44,179
Other comprehensive income, net of tax				
Unrealized net holding gains arising during the period (pre-tax amounts of $1,463,$5,978, $1,798 and $13,719)	878	3,609	1,079	8,284
Reclassification adjustment for net gains related to securities available for sale included in net income (pre-tax amounts of $26, $12, $578 and $98)	(16)	(7)	(347)	(59)
Pension and other benefits:				
Amortization of prior service cost and actuarial gains (pre-tax amounts of $989, $417, $2,702 and $1,248)	599	250	1,626	749
Total other comprehensive income	1,461	3,852	2,358	8,974
Comprehensive income	$ 15,996	$ 19,069	$ 43,800	$ 53,153

See accompanying notes to unaudited interim consolidated financial statements

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

(in thousands, except share and per share data)	Common Stock	Additional Paid-in-Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Common Stock in Treasury	Total
Balance at December 31, 2010	$ 380	$ 314,023	$ 299,797	$ (5,335)	$ (75,293)	$ 533,572
Net income	-	-	44,179	-	-	44,179
Cash dividends - $0.60 per share	-	-	(20,439)	-	-	(20,439)
Purchase of 1,458,609 treasury shares	-	-	-	-	(30,502)	(30,502)
Net issuance of 59,128 shares to employee benefit plans and other stock plans, including tax benefit	-	(420)	(137)	-	1,185	628
Stock-based compensation	-	2,436	-	-	-	2,436
Other comprehensive income	-	-	-	8,974	-	8,974
Balance at September 30, 2011	$ 380	$ 316,039	$ 323,400	$ 3,639	$ (104,610)	$ 538,848
Balance at December 31, 2011	$ 380	$ 317,329	$ 329,981	$ (6,104)	$ (103,476)	$ 538,110

Net income	-	-	41,442	-	-	41,442
Cash dividends - $0.60 per share	-	-	(19,966)	-	-	(19,966)
Purchase of 769,568 treasury shares	-	-	-	-	(15,490)	(15,490)
Net issuance of 1,269,592 shares for acquisition	13	25,811	-	-	-	25,824
Net issuance of 85,943 shares to employee benefit plans and other stock plans, including tax benefit	-	(764)	(196)	-	1,785	825
Stock-based compensation	-	3,558	-	-	-	3,558
Other comprehensive income	-	-	-	2,358	-	2,358
Balance at September 30, 2012	$ 393	$ 345,934	$ 351,261	$ (3,746)	$ (117,181)	$ 576,661

See accompanying notes to unaudited interim consolidated financial statements.

NBT Bancorp Inc. and Subsidiaries Consolidated Statements of Cash Flows (unaudited) (In thousands, except per share data)	Nine months ended September 30, 2012	2011
Operating activities		
Net income	$ 41,442	$ 44,179
Adjustments to reconcile net income to net cash provided by operating activities		
Provision for loan and lease losses	13,329	15,161
Depreciation and amortization of premises and equipment	4,636	4,023
Net accretion on securities	1,766	939
Amortization of intangible assets	2,530	2,286
Stock based compensation	3,558	2,436
Bank owned life insurance income	(2,228)	(2,369)
Purchases of trading securities	(705)	(404)
Unrealized (gains) losses in trading securities	(84)	247
Deferred income tax benefit	(2,735)	(4,003)
Proceeds from sales of loans held for sale	37,922	3,257
Originations and purchases of loans held for sale	(47,263)	(2,445)
Net gains on sales of loans held for sale	(1,352)	(2)
Net security gains	(578)	(98)
Net gain on sales of other real estate owned	(602)	(712)
Net decrease in other assets	9,316	3,499
Net (decrease) increase in other liabilities	(1,213)	1,532
Net cash provided by operating activities	57,739	67,526
Investing activities		
Net cash provided by (used in) acquisitions	53,121	(1,000)
Securities available for sale:		
Proceeds from maturities, calls, and principal paydowns	381,160	360,358
Proceeds from sales	1,791	118
Purchases	(329,378)	(387,855)
Securities held to maturity:		
Proceeds from maturities, calls, and principal paydowns	24,428	39,766
Purchases	(14,959)	(14,580)
Net increase in loans	(234,330)	(115,065)
Net (increase) decrease in Federal Reserve and FHLB stock	(672)	226
Purchases of premises and equipment	(4,805)	(5,677)
Proceeds from sales of other real estate owned	2,411	2,073
Net cash used in investing activities	(121,233)	(121,636)
Financing activities		
Net increase in deposits	156,761	130,712
Net decrease in short-term borrowings	(44,227)	(1,149)
Repayments of long-term debt	(3,350)	(2,143)
Issuance of long-term debt	-	156
Excess tax benefit from exercise of stock options	(13)	(95)
Proceeds from the issuance of shares to employee benefit plans and other stock plans	838	723
Purchase of treasury stock	(15,490)	(30,502)
Cash dividends and payment for fractional shares	(19,966)	(20,439)
Net cash provided by financing activities	74,553	77,263

Net increase in cash and cash equivalents	11,059	23,153
Cash and cash equivalents at beginning of period	129,381	168,792
Cash and cash equivalents at end of period	$ 140,440	$ 191,945

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Supplemental disclosure of cash flow information		
Cash paid during the period for:		
Interest	$26,951	$30,774
Income taxes paid	18,457	22,537
Noncash investing activities:		
Loans transferred to OREO	$1,503	$1,110
Acquisitions:		
Fair value of assets acquired	$257,865	$3,460
Fair value of liabilities assumed	285,012	3,426
Fair value of debt issued in purchase combination	150	2,460

See accompanying notes to unaudited interim consolidated financial statements.

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NBT BANCORP INC. and Subsidiaries
NOTES TO UNAUDITED INTERIM CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2012

Note 1.Description of Business

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

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

Note 2. Basis of Presentation

The accompanying unaudited interim consolidated financial statements include the accounts of the Registrant and its wholly owned subsidiaries, the Bank, NBT Financial and NBT Holdings. Collectively, the Registrant and its subsidiaries are referred to herein as “the Company.” All intercompany transactions have been eliminated in consolidation. Amounts in the prior period financial statements are reclassified whenever necessary to conform to current period presentation. The Company has evaluated subsequent events for potential recognition and/or disclosure and there were none identified.

Note 3.Acquisition

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

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

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

Consideration Paid:	
NBT Bancorp common stock issued to Hampshire First common stockholders	$25,824
Cash consideration paid to Hampshire First common stockholders	14,616
Cash consideration paid for Hampshire First employee stock options and warrants	2,583
Total consideration paid	$43,023
Recognized Amounts of Identifiable Assets Acquired and (Liabilities Assumed), At Fair Value:	
Cash and short term investments	$22,149
Loans	218,801
Federal Home Loan Bank common stock	1,014
Core deposit intangibles	797
Other assets	12,926
Deposits	(228,198)
Borrowings	(41)
Other liabilities	(2,848)
Total identifiable net assets	$24,600
Goodwill	$18,423

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

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

Contractually required principal and interest at acquisition	$226,631
Contractual cash flows not expected to be collected	(7,985)
Expected cash flows at acquisition	218,646
Interest component of expected cash flows (accretable premium)	155
Fair value of acquired loans	$218,801

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

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

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

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Note 4.Subsequent Event

On October 7, 2012, the Company and Alliance Financial Corporation ("Alliance") entered into a definitive agreement and plan of merger pursuant to which Alliance will merge with and into NBT Bancorp, with NBT Bancorp continuing as the surviving corporation. The agreement also provides for Alliance Bank, N.A., a wholly-owned subsidiary of Alliance, to be merged with and into the Bank following completion of the merger. Alliance, with assets of approximately $1.4 billion at June 30, 2012, is headquartered in Syracuse, N.Y. Its primary subsidiary, Alliance Bank, N.A., is a nationally-chartered community bank with 28 banking locations in central New York. The transaction is valued at approximately $233.4 million, to be paid in the form of shares of the Company's common stock. Subject to the required approvals of NBT Bancorp and Alliance shareholders, requisite regulatory approvals and other customary closing conditions, the merger is expected to be completed in the early 2013.

Note 5.Use of Estimates

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

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

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

Management believes that the allowance for loan losses is adequate. While management uses available information to recognize loan losses, future additions or reductions to the allowance for loan losses may be necessary based on changes in economic conditions or changes in the values of properties securing loans in the process of foreclosure. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Company's allowance for loan losses. Such agencies may require the Company to recognize additions to the allowance for loan losses based on their judgments about information available to them at the time of their examination which may not be currently available to management. In determining that we will be unable to collect all principal and interest payments due in accordance with the contractual terms of the loan agreements, we consider factors such as payment history and changes in the financial condition of individual borrowers, local economic conditions, historical loss experience and the conditions of the various markets in which the collateral may be liquidated.

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

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

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

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

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

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Beginning in June 2012 with the acquisition of Hampshire First Bank, the Bank offers interest rate swap agreements to its customers. These agreements allow the Bank's customers to effectively fix the interest rate on a variable rate loan by entering into a separate agreement. Simultaneous with the execution of such an agreement with a customer, the Bank enters into a matching interest rate swap agreement with an unrelated third party provider, which allows the Bank to continue to receive the historical variable rate under the loan agreement with the customer. The agreement with the third party is not a hedge contract therefore changes in fair value are recorded through earnings. Assets and liabilities associated with the agreements are recorded in other assets and other liabilities on the balance sheet. Gains and losses are recorded as other noninterest income. The Bank is not subject to any fee or penalty should the customer elect to terminate the interest rate swap agreement prior to maturity. The Bank is exposed to credit loss equal to the fair value of the derivatives (not the notional amount of the derivatives) in the event of nonperformance by the counterparty to the interest rate swap agreements. Additionally, the Bank receives a fee from the customer that is recognized when the Bank has fulfilled its obligations under each agreement, which is generally upon execution of the agreement with the Bank's customer. Since the terms of the two interest rate swap agreements are identical, the income statement impact to the Bank is limited to the fees it receives from the customer. The Bank recognized minimal fee income for the nine months ended September 30, 2012. At September 30, 2012, the Bank maintained a $1.6 million deposit with the counterparty to collateralize the swap agreements.

Note 6.Commitments and Contingencies

The Company is a party to financial instruments in the normal course of business to meet the financing needs of its customers and to reduce its own exposure to fluctuating interest rates. These financial instruments include commitments to extend credit, unused lines of credit, and standby letters of credit. Exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to make loans and standby letters of credit is represented by the contractual amount of those instruments. The Company uses the same credit origination guidelines, portfolio maintenance and management procedures as other credit and off-balance sheet products. Commitments to extend credit and unused lines of credit totaled $861.7 million at September 30, 2012 and $764.9 million at December 31, 2011. Since commitments to extend credit and unused lines of credit may expire without being fully drawn upon, this amount does not necessarily represent future cash commitments. Collateral obtained upon exercise of the commitment is determined using management's credit evaluation of the borrower and may include accounts receivable, inventory, property, land and other items.

The Company guarantees the obligations or performance of customers by issuing standby letters of credit to third parties. These standby letters of credit are frequently issued in support of third party debt, such as corporate debt issuances, industrial revenue bonds and municipal securities. The credit risk involved in issuing standby letters of credit is essentially the same as the credit risk involved in extending loan facilities to customers, and they are subject to the same credit origination guidelines, portfolio maintenance and management procedures as other credit and off-balance sheet products. Typically, these instruments have terms of five years or less and expire unused; therefore, the total amounts do not necessarily represent future cash commitments. Standby letters of credit totaled $33.0 million at September 30, 2012 and $26.8 million at December 31, 2011. As of September 30, 2012, the fair value of standby letters of credit was not significant to the Company's consolidated financial statements.

The Company has also entered into commercial letter of credit agreements on behalf of its customers. Under these agreements, the Company, on the request of its customer, opens the letter of credit and makes a commitment to honor draws made under the agreement, whereby the beneficiary is normally the provider of goods and/or services and the Company essentially replaces the customer as the payee. The credit risk involved in issuing commercial letters of credit is essentially the same as the credit risk involved in extending loan facilities to customers, and they are subject to the same credit origination guidelines, portfolio maintenance and management procedures as other credit and off-balance sheet products. Typically, these agreements vary in terms and the total amounts do not necessarily represent future cash commitments. Commercial letters of credit totaled $8.3 million at September 30, 2012 and

$15.2 million at December 31, 2011. As of September 30, 2012, the fair value of commercial letters of credit was not significant to the Company’s consolidated financial statements.

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Note 7. Allowance for Loan Losses and Credit Quality of Loans

Allowance for Loan Losses

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

To develop and document a systematic methodology for determining the allowance for loan losses, the Company has divided the loan portfolio into three portfolio segments, each with different risk characteristics and methodologies for assessing risk. Each portfolio segment is broken down into class segments where appropriate. Class segments contain unique measurement attributes, risk characteristics and methods for monitoring and assessing risk that are necessary to develop the allowance for loan losses. Unique characteristics such as borrower type, loan type, collateral type, and risk characteristics define each class segment. The following table illustrates the portfolio and class segments for the Company's loan portfolio:

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

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

Commercial Real Estate – The Company offers commercial real estate loans to finance real estate purchases, refinancings, expansions and improvements to commercial properties. Commercial real estate loans are made to finance the purchases of real property which generally consists of real estate with completed structures. These commercial real estate loans are secured by first liens on the real estate, which may include apartments, commercial structures, housing businesses, healthcare facilities, and other non owner-occupied facilities. These loans are typically less risky than commercial loans, since they are secured by real estate and buildings. The Company's underwriting analysis includes credit verification, independent appraisals, a review of the borrower's financial condition, and a detailed analysis of the borrower's underlying cash flows. These loans are typically originated in amounts of no more than 80% of the appraised value of the property.

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

Agricultural Real Estate – The Company offers real estate loans to our agricultural customers to finance farm related real estate purchases, refinancings, expansions, and improvements to agricultural properties such as barns, production facilities, and land. The agricultural real estate loans are secured by first liens on the farm real estate. Because they are secured by land and buildings, these loans may be less risky than agricultural loans. The Company's underwriting analysis includes credit verification, independent appraisals, a review of the borrower's financial condition, and a detailed analysis of the borrower’s underlying cash flows. These loans are typically originated in amounts of no more than 75% of the appraised value of the property. Government loan guarantees may be obtained to provide further support.

Business Banking - The Company offers a variety of loan options to meet the specific needs of our business banking customers including term loans, business banking mortgages and lines of credit. Such loans are generally less than $350 thousand and are made available to businesses for working capital such as inventory and receivables, business expansion, equipment purchases, and agricultural needs. Generally, a collateral lien is placed on equipment or other assets owned by the borrower such as inventory and/or receivables. These loans carry a higher risk than commercial loans due to the smaller size of the borrower and lower levels of capital. To reduce the risk, the Company obtains personal guarantees of the owners for a majority of the loans.

Indirect – The Company maintains relationships with many dealers primarily in the communities that we serve. Through these relationships, the company finances the purchases of automobiles and recreational vehicles (such as campers, boats, etc.) indirectly through dealer relationships. Approximately 70% of the indirect relationships represent automobile financing. Most of these loans carry a fixed rate of interest with principal repayment terms typically ranging from three to six years, based upon the nature of the collateral and the size of the loan. The majority of indirect consumer loans are underwritten on a secured basis using the underlying collateral being financed.

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

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

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Residential Real Estate – Residential real estate loans consist primarily of loans secured by first or second deeds of trust on primary residences. We originate adjustable-rate and fixed-rate, one-to-four-family residential real estate loans for the construction, purchase or refinancing of a mortgage. These loans are collateralized by owner-occupied properties located in the Company's market area. When market conditions are favorable, for longer term, fixed-rate residential mortgages without escrow, the Company retains the servicing, but sells the right to receive principal and interest to Freddie Mac.   This practice allows the Company to manage interest rate risk, liquidity risk, and credit risk. Loans on one-to-four-family residential real estate are generally originated in amounts of no more than 85% of the purchase price or appraised value (whichever is lower), or have private mortgage insurance. Mortgage title insurance and hazard insurance are normally required. Construction loans have a unique risk, because they are secured by an incomplete dwelling. This risk is reduced through periodic site inspections, including one at each loan draw period.

Allowance for Loan Loss Calculation

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

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

After a thorough consideration of the factors discussed above, any required additions or reductions to the allowance for loan losses are made periodically by charges or credits to the provision for loan losses. These charges or credits are necessary to maintain the allowance at a level which management believes is reasonably reflective of overall inherent risk of probable loss in the portfolio. While management uses available information to recognize losses on loans, additions and reductions of the allowance may fluctuate from one reporting period to another. These fluctuations are reflective of changes in risk associated with portfolio content and/or changes in management's assessment of any or all of the determining factors discussed above. The following table illustrates the changes in the allowance for loan losses by portfolio segment for the three and nine months ended September 30, 2012 and September 30, 2011:

Allowance for Loan Losses
(in thousands)

	Commercial Loans	Consumer Loans	Residential Real Estate Mortgages	Unallocated	Total
Balance as of June 30, 2012	$ 37,495	$ 27,235	$ 5,943	$ 61	$ 70,734
Charge-offs	(1,904)	(3,446)	(480)	-	(5,830)
Recoveries	492	574	9	-	1,075
Provision	1,734	2,213	809	(1)	4,755
Ending Balance as of September 30, 2012	$ 37,817	$ 26,576	$ 6,281	$ 60	$ 70,734
Balance as of June 30, 2011	$ 39,147	$ 25,718	$ 5,373	$ 246	$ 70,484
Charge-offs	(1,694)	(3,526)	(45)	-	(5,265)
Recoveries	367	571	2	-	940
Provision	1,073	3,533	588	(19)	5,175
Ending Balance as of September 30, 2011	$ 38,893	$ 26,296	$ 5,918	$ 227	$ 71,334

	Commercial Loans	Consumer Loans	Residential Real Estate Mortgages	Unallocated	Total
Balance as of December 31, 2011	$ 38,831	$ 26,049	$ 6,249	$ 205	$ 71,334
Charge-offs	(4,685)	(11,237)	(1,130)	-	(17,052)
Recoveries	1,180	1,918	25	-	3,123
Provision	2,491	9,846	1,137	(145)	13,329
Ending Balance as of September 30, 2012	$ 37,817	$ 26,576	$ 6,281	$ 60	$ 70,734
Balance as of December 31, 2010	$ 40,101	$ 26,126	$ 4,627	$ 380	$ 71,234
Charge-offs	(7,153)	(10,420)	(558)	-	(18,131)
Recoveries	1,262	1,803	5	-	3,070
Provision	4,683	8,787	1,844	(153)	15,161
Ending Balance as of September 30, 2011	$ 38,893	$ 26,296	$ 5,918	$ 227	$ 71,334

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

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

	Commercial Loans	Consumer Loans	Residential Real Estate Mortgages	Unallocated	Total
As of September 30, 2012					
Allowance for loan losses	$ 37,817	$ 26,576	$ 6,281	$ 60	$ 70,734
Allowance for loans individually evaluated for impairment	2,720	-	-		2,720
Allowance for loans collectively evaluated for impairment	$ 35,097	$ 26,576	$ 6,281	$ 60	$ 68,014
Ending balance of loans	$ 1,992,891	$ 1,607,780	$ 650,448		$ 4,251,119
Ending balance of loans individually evaluated for impairment	13,017	-	-		13,017
Ending balance of loans collectively evaluated for impairment	$ 1,979,874	$ 1,607,780	$ 650,448		$ 4,238,102
As of December 31, 2011					
Allowance for loan losses	$ 38,831	$ 26,049	$ 6,249	$ 205	$ 71,334
Allowance for loans individually evaluated for impairment	175	-	-		175
Allowance for loans collectively evaluated for impairment	$ 38,656	$ 26,049	$ 6,249	$ 205	$ 71,159
Ending balance of loans	$ 1,702,577	$ 1,516,115	$ 581,511		$ 3,800,203
Ending balance of loans individually evaluated for impairment	6,219	-	-		6,219
Ending balance of loans collectively evaluated for impairment	$ 1,696,358	$ 1,516,115	$ 581,511		$ 3,793,984

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Credit Quality of Loans

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

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

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

Loans on Nonaccrual Status
As of September 30, 2012

(In thousands)	September 30, 2012	December 31, 2011
Commercial Loans		
Commercial	$ 6,915	$ 1,699
Commercial Real Estate	6,432	4,868
Agricultural	2,587	3,307
Agricultural Real Estate	1,195	2,067
Business Banking	5,921	7,446
	23,050	19,387
Consumer Loans		
Indirect	1,703	1,550
Home Equity	8,126	7,931
Direct	257	378
	10,086	9,859
Residential Real Estate Mortgages	9,525	9,044
Total Nonaccrual	$ 42,661	$ 38,290

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

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

Age Analysis of Past Due Financing Receivables
As of September 30, 2012
(in thousands)

	31-60 Days Past Due Accruing	61-90 Days Past Due Accruing	Greater Than 90 Days Past Due Accruing	Total Past Due Accruing	Non-Accrual	Current	Recorded Total Loans
Commercial Loans							
Commercial	$707	$149	$ -	$856	$ 6,915	$594,775	$602,546
Commercial Real Estate	1,455	138	-	1,593	6,432	1,012,695	1,020,720
Agricultural	-	-	-	-	2,587	64,187	66,774
Agricultural Real Estate	-	-	-	-	1,195	35,348	36,543
Business Banking	1,114	555	80	1,749	5,921	258,638	266,308
	3,276	842	80	4,198	23,050	1,965,643	1,992,891
Consumer Loans							
Indirect	9,406	1,729	978	12,113	1,703	948,803	962,619
Home Equity	5,478	888	573	6,939	8,126	561,143	576,208
Direct	705	130	47	882	257	67,814	68,953
	15,589	2,747	1,598	19,934	10,086	1,577,760	1,607,780
Residential Real Estate Mortgages	2,240	170	1,285	3,695	9,525	637,228	650,448
	$21,105	$3,759	$ 2,963	$27,827	$ 42,661	$4,180,631	$4,251,119

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Age Analysis of Past Due Financing Receivables
As of December 31, 2011
(in thousands)

	31-60 Days Past Due Accruing	61-90 Days Past Due Accruing	Greater Than 90 Days Past Due Accruing	Total Past Due Accruing	Non-Accrual	Current	Recorded Total Loans
Commercial Loans							
Commercial	$663	$50	$ -	$713	$ 1,699	$508,662	$511,074
Commercial Real Estate	1,942	-	-	1,942	4,868	828,089	834,899
Agricultural	77	13	-	90	3,307	63,140	66,537