CAMDEN NATIONAL CORP
Form 10-Q
August 02, 2013

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

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended June 30, 2013
OR
¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934
Commission File No. 0-28190
CAMDEN NATIONAL CORPORATION
(Exact name of registrant as specified in its charter)

MAINE	01-0413282
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
2 ELM STREET, CAMDEN, ME	04843
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number, including area code: (207) 236-8821

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 periods that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes x No ¨

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

Yes x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See 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 ¨	Accelerated filer x
Non-accelerated filer ¨ (Do not check if a smaller reporting company)	Smaller reporting company ¨

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

Yes ¨ No x

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practical date:
Outstanding at August 1, 2013: Common stock (no par value) 7,640,712 shares.

CAMDEN NATIONAL CORPORATION

FORM 10-Q FOR THE QUARTER ENDED JUNE 30, 2013
TABLE OF CONTENTS OF INFORMATION REQUIRED IN REPORT

PART I. FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Shareholders and Board of Directors
Camden National Corporation

We have reviewed the accompanying interim consolidated financial information of Camden National Corporation (the “Company”) and Subsidiaries as of June 30, 2013, and for the three and six-month periods ended June 30, 2013 and 2012. These financial statements are the responsibility of the Company's management.

We conducted our reviews in accordance with standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures to financial data and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit in accordance with standards of the Public Company Accounting Oversight Board (United States), the objective of which is to express an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our reviews, we are not aware of any material modifications that should be made to the accompanying financial statements for them to be in conformity with accounting principles generally accepted in the United States of America.

/s/ Berry Dunn McNeil & Parker, LLC
Berry Dunn McNeil & Parker, LLC

Bangor, Maine
August 2, 2013

CAMDEN NATIONAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CONDITION

(In Thousands, Except Number of Shares)	June 30, 2013 (unaudited)	December 31, 2012
ASSETS		
Cash and due from banks	$44,896	$58,290
Securities		
Securities available-for-sale, at fair value	789,369	781,050
Federal Home Loan Bank and Federal Reserve Bank stock, at cost	19,724	21,034
Total securities	809,093	802,084
Trading account assets	2,281	2,300
Loans held for sale	2,826	—
Loans	1,602,559	1,563,866
Less allowance for loan losses	(23,321)	(23,044)
Net loans	1,579,238	1,540,822
Goodwill and other intangible assets	52,725	53,299
Bank-owned life insurance	45,705	45,053
Premises and equipment, net	26,890	28,059
Deferred tax asset	13,962	7,663
Interest receivable	6,506	6,215
Other real estate owned	2,155	1,313
Other assets	15,501	19,659
Total assets	$2,601,778	$2,564,757
LIABILITIES AND SHAREHOLDERS' EQUITY		
Liabilities		
Deposits		
Demand	$232,535	$240,749
Interest checking, savings and money market	1,160,933	1,169,148
Retail certificates of deposit	393,158	418,442
Brokered deposits	107,461	101,130
Total deposits	1,894,087	1,929,469
Federal Home Loan Bank advances	186,147	56,404
Other borrowed funds	218,318	259,940
Junior subordinated debentures	43,870	43,819
Accrued interest and other liabilities	29,736	41,310
Total liabilities	2,372,158	2,330,942
Shareholders' Equity		
Common stock, no par value; authorized 20,000,000 shares, issued and outstanding 7,640,712 and 7,622,750 shares on June 30, 2013 and December 31, 2012, respectively	49,909	49,667
Retained earnings	189,007	181,151
Accumulated other comprehensive income (loss)		
Net unrealized (losses) gains on securities available-for-sale, net of tax	(2,590)	12,943
Net unrealized losses on derivative instruments, at fair value, net of tax	(4,059)	(7,205)
Net unrecognized losses on postretirement plans, net of tax	(2,647)	(2,741)
Total accumulated other comprehensive income (loss)	(9,296)	2,997
Total shareholders' equity	229,620	233,815
Total liabilities and shareholders' equity	$2,601,778	$2,564,757

See Report of Independent Registered Public Accounting Firm.
The accompanying notes are an integral part of these consolidated financial statements.

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CAMDEN NATIONAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME
(unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
(In Thousands, Except Number of Shares and Per Share Data)	2013	2012	2013	2012
Interest Income				
Interest and fees on loans	$18,059	$18,268	$35,854	$36,703
Interest on U.S. government and sponsored enterprise obligations	4,074	4,118	8,350	8,234
Interest on state and political subdivision obligations	292	355	597	720
Interest on federal funds sold and other investments	56	56	106	105
Total interest income	22,481	22,797	44,907	45,762
Interest Expense				
Interest on deposits	1,828	2,390	3,647	4,928
Interest on borrowings	767	1,409	1,585	2,827
Interest on junior subordinated debentures	636	632	1,257	1,270
Total interest expense	3,231	4,431	6,489	9,025
Net interest income	19,250	18,366	38,418	36,737
Provision for credit losses	695	835	1,369	1,840
Net interest income after provision for credit losses	18,555	17,531	37,049	34,897
Non-Interest Income				
Service charges on deposit accounts	1,755	1,315	3,439	2,471
Other service charges and fees	1,513	956	2,942	1,801
Income from fiduciary services	1,275	1,289	2,418	2,728
Mortgage banking income, net	584	132	1,158	468
Brokerage and insurance commissions	409	410	821	749
Bank-owned life insurance	314	342	652	681
Net gain on sale of securities and other-than-temporary impairment of securities	—	751	138	872
Other income	526	559	1,144	1,212
Total non-interest income	6,376	5,754	12,712	10,982
Non-Interest Expenses				
Salaries and employee benefits	7,961	6,972	16,322	13,880
Furniture, equipment and data processing	1,931	1,295	3,535	2,518
Net occupancy	1,407	1,020	2,959	2,131
Other real estate owned and collection costs (recoveries), net	(22)	497	866	1,123
Consulting and professional fees	585	608	1,132	1,098
Regulatory assessments	500	432	999	867
Amortization of intangible assets	287	145	574	289
Branch acquisition/divestiture costs	71	—	232	—
Other expenses	2,928	3,010	5,529	4,992
Total non-interest expenses	15,648	13,979	32,148	26,898
Income before income taxes	9,283	9,306	17,613	18,981
Income Taxes	2,952	2,894	5,620	5,986
Net Income	$6,331	$6,412	$11,993	$12,995
Per Share Data				
Basic earnings per share	$0.83	$0.84	$1.57	$1.69
Diluted earnings per share	$0.82	$0.83	$1.56	$1.69

Weighted average number of common shares outstanding	7,637,433	7,675,819	7,632,586	7,673,927
Diluted weighted average number of common shares outstanding	7,652,199	7,687,620	7,646,742	7,686,747

See Report of Independent Registered Public Accounting Firm.
The accompanying notes are an integral part of these consolidated financial statements.

CAMDEN NATIONAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
(unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
(In Thousands)	2013	2012	2013	2012
Net income	$6,331	$6,412	$11,993	$12,995
Other comprehensive income (loss), net of related tax effects:				
Unrealized (losses) gains on securities available-for-sale:				
Unrealized holding (losses) gains on securities available-for-sale arising during period, net of related tax effects of $6,808, ($1,475), $8,315 and ($819), respectively	(12,644)	2,740	(15,443)	1,521
Less: reclassification adjustment for gains included in net income, net of related tax effects of $0, $263, $48 and $305, respectively	—	(488)	(90)	(567)
Net unrealized gains (losses) on securities available-for-sale	(12,644)	2,252	(15,533)	954
Unrealized gain (loss) on cash flow hedging derivatives, net of related tax effects of ($1,236), $1,227, ($1,694) and $406, respectively	2,296	(2,279)	3,146	(754)
Postretirement plans:				
Net actuarial gain arising during period, net of related tax effects of ($21), ($13), ($42) and ($26), respectively	40	24	79	48
Plus: amortization of prior service cost included in net periodic cost, net of related tax effects of ($4), ($2) ($8) and ($3)(1), respectively	7	3	15	6
Other comprehensive income (loss)	(10,301)	—	(12,293)	254
Comprehensive income (loss)	$(3,970)	$6,412	$(300)	$13,249

(1) Reclassified into the consolidated statements of income in salaries and employee benefits.

See Report of Independent Registered Public Accounting Firm.
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CAMDEN NATIONAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
(unaudited)

(In Thousands, Except Number of Shares and Per Share Data)	Common Stock Shares Outstanding	Common Stock Amount	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Shareholders' Equity
Balance at December 31, 2011	7,664,975	$51,438	$165,377	$2,061	$218,876
Net income	—	—	12,995	—	12,995
Other comprehensive income (loss), net of tax:					
Change in fair value of securities available-for-sale	—	—	—	954	954
Change in fair value of cash flow hedges	—	—	—	(754)	(754)
Change in net unrecognized losses on postretirement plans	—	—	—	54	54
Total comprehensive income	—	—	12,995	254	13,249
Stock-based compensation expense	—	172	—	—	172
Exercise of stock options and issuance of restricted stock, net of repurchase for tax withholdings and tax benefit	19,614	(240)	—	—	(240)
Common stock repurchased	(65,580)	(2,097)	—	—	(2,097)
Cash dividends declared ($0.50 per share)	—	—	(3,872)	—	(3,872)
Balance at June 30, 2012	7,619,009	$49,273	$174,500	$2,315	$226,088
Balance at December 31, 2012	7,622,750	$49,667	$181,151	$2,997	$233,815
Net income	—	—	11,993	—	11,993
Other comprehensive income (loss), net of tax:					
Change in fair value of securities available-for-sale	—	—	—	(15,533)	(15,533)
Change in fair value of cash flow hedges	—	—	—	3,146	3,146
Change in net unrecognized losses on postretirement plans	—	—	—	94	94
Total comprehensive loss	—	—	11,993	(12,293)	(300)
Stock-based compensation expense	—	159	—	—	159
Exercise of stock options and issuance of restricted stock, net of repurchase for tax withholdings and tax benefit	17,962	83	—	—	83
Cash dividends declared ($0.54 per share)	—	—	(4,137)	—	(4,137)
Balance at June 30, 2013	7,640,712	$49,909	$189,007	$(9,296)	$229,620

See Report of Independent Registered Public Accounting Firm.
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CAMDEN NATIONAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(unaudited)

	Six Months Ended June 30,	
(In Thousands)	2013	2012
Operating Activities		
Net income	$11,993	$12,995
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for credit losses	1,369	1,840
Depreciation and amortization	2,799	2,139
Stock-based compensation expense	159	172
Increase in interest receivable	(291)	(99)
Amortization of intangible assets	574	289
Net decrease in trading assets	19	60
Net investment securities gains and other-than-temporary impairment of securities	(138)	(872)
Increase in other real estate owned valuation allowance and loss on disposition	31	247
Originations of mortgage loans held for sale	(21,510)	(12,775)
Proceeds from the sale of mortgage loans	19,336	19,104
Gain on sale of mortgage loans	(652)	(268)
Decrease in prepaid FDIC assessment	3,606	575
(Increase) decrease in other assets	(376)	1,034
(Decrease) increase in other liabilities	(3,456)	1,099
Net cash provided by operating activities	13,463	25,540
Investing Activities		
Proceeds from sales and maturities of securities available-for-sale	75,669	110,644
Purchase of securities available-for-sale	(108,954)	(196,419)
Net increase in loans	(40,340)	(25,585)
Proceeds from sale of Federal Home Loan Bank stock	1,310	928
Proceeds from the sale of other real estate owned	103	627
Proceeds from previously charge-off loans	325	384
Cash settlement in branch acquisition	(3,278)	—
Purchase of premises and equipment	(586)	(968)
Net cash used by investing activities	(75,751)	(110,389)
Financing Activities		
Net (decrease) increase in deposits	(35,382)	10,496
Repayments on Federal Home Loan Bank long-term advances	(257)	(243)
Net change in short-term Federal Home Loan Bank borrowings	148,100	125,000
Net decrease in other borrowed funds	(59,672)	(43,068)
Common stock repurchase	—	(2,097)
Exercise of stock options and issuance of restricted stock, net of repurchase for tax withholdings and tax benefit	83	(240)
Cash dividends paid on common stock	(3,978)	(3,846)
Net cash provided by financing activities	48,894	86,002
Net (decrease) increase in cash and cash equivalents	(13,394)	1,153
Cash and cash equivalents at beginning of year	58,290	39,325
Cash and cash equivalents at end of period	$44,896	$40,478
Supplemental information		
Interest paid	$6,765	$9,190

Income taxes paid	5,400	3,322
Transfer from loans to other real estate owned	976	889

See Report of Independent Registered Public Accounting Firm.
The accompanying notes are an integral part of these consolidated financial statements.

CAMDEN NATIONAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Amounts in Tables Expressed in Thousands, Except Number of Shares and per Share Data)

NOTE 1 - BASIS OF PRESENTATION

The accompanying unaudited consolidated financial statements were prepared in accordance with instructions for Form 10-Q and, therefore, do not include all disclosures required by accounting principles generally accepted in the United States of America ("GAAP") for complete presentation of financial statements. In the opinion of management, the consolidated financial statements contain all adjustments (consisting only of normal recurring accruals) necessary to present fairly the consolidated statements of condition of Camden National Corporation (the "Company") as of June 30, 2013 and December 31, 2012, the consolidated statements of income for the three and six months ended June 30, 2013 and 2012, the consolidated statements of comprehensive income (loss) for the three and six months ended June 30, 2013 and 2012, the consolidated statements of changes in shareholders' equity for the six months ended June 30, 2013 and 2012, and the consolidated statements of cash flows for the six months ended ended June 30, 2013 and 2012. All significant intercompany transactions and balances are eliminated in consolidation. Certain items from the prior year were reclassified to conform to the current year presentation. The income reported for the three and six months period ended June 30, 2013 is not necessarily indicative of the results that may be expected for the full year. The information in this report should be read in conjunction with the consolidated financial statements and accompanying notes included in the Annual Report for the year ended December 31, 2012, Form 10-K.

NOTE 2 – EARNINGS PER SHARE

The following is an analysis of basic and diluted earnings per share ("EPS"), reflecting the application of the two-class method, as described below:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Net income	$6,331	$6,412	$11,993	$12,995
Dividends and undistributed earnings allocated to participating securities [(1)]	(20)	(18)	(30)	(30)
Net income available to common shareholders	$6,311	$6,394	$11,963	$12,965
Weighted-average common shares outstanding for basic EPS	7,637,433	7,675,819	7,632,586	7,673,927
Dilutive effect of stock-based awards [(2)]	14,766	11,801	14,156	12,820
Weighted-average common and potential common shares for diluted EPS	7,652,199	7,687,620	7,646,742	7,686,747
Earnings per common share:				
Basic EPS	$0.83	$0.84	$1.57	$1.69
Diluted EPS	$0.82	$0.83	$1.56	$1.69

(1) Represents dividends paid and undistributed earnings allocated to nonvested restricted stock awards.

(2) Represents the effect of the assumed exercise of stock options, vesting of restricted shares, and vesting of restricted stock units, based on the treasury stock method.

Nonvested stock-based payment awards that contain non-forfeitable rights to dividends are participating securities and are included in the computation of earnings per share pursuant to the two-class method. The two-class method is an earnings allocation formula that determines earnings per share for each class of common stock and participating security according to dividends declared (or accumulated) and participation rights in undistributed earnings. Certain of the Company’s nonvested restricted stock awards qualify as participating securities.

Net income, less any preferred dividends accumulated for the period (whether or not declared), is allocated between the common stock and participating securities pursuant to the two-class method. Basic EPS is computed by dividing net income available to common shareholders by the weighted average number of common shares outstanding during the period, excluding participating nonvested restricted shares.

Diluted EPS is computed in a similar manner, except that first the denominator is increased to include the number of additional common shares that would have been outstanding if potentially dilutive common shares were issued using the treasury stock method.

For both the three and six month periods ended June 30, 2013, options to purchase 48,000 shares of common stock were not considered in the computation of potential common shares for purposes of diluted EPS, since the exercise prices of the options were greater than the average market price of the common stock for the respective periods. For the three month and six month periods ended June 30, 2012, options to purchase 75,000 and 50,000 shares, respectively, of common stock were not considered in the computation of potential common shares for purposes of diluted EPS, since the exercise prices of the options were greater than the average market price of the common stock for the respective periods.

NOTE 3 – SECURITIES

The following tables summarize the amortized costs and estimated fair values of securities available-for-sale ("AFS"), as of June 30, 2013 and December 31, 2012:

	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
June 30, 2013				
Obligations of states and political subdivisions	$29,079	$1,410	$—	$30,489
Mortgage-backed securities issued or guaranteed by U.S. government sponsored enterprises	347,342	6,837	(5,401)	348,778
Collateralized mortgage obligations issued or guaranteed by U.S. government sponsored enterprises	408,826	1,271	(7,840)	402,257
Private issue collateralized mortgage obligations	8,106	12	(273)	7,845
Total securities available-for-sale	$793,353	$9,530	$(13,514)	$789,369
December 31, 2012				
Obligations of states and political subdivisions	$31,112	$1,928	$—	$33,040
Mortgage-backed securities issued or guaranteed by U.S. government sponsored enterprises	345,528	12,699	(79)	358,148
Collateralized mortgage obligations issued or guaranteed by U.S. government sponsored enterprises	375,627	6,181	(120)	381,688
Private issue collateralized mortgage obligations	8,871	—	(697)	8,174
Total securities available-for-sale	$761,138	$20,808	$(896)	$781,050

Net unrealized gains (losses) on securities AFS at June 30, 2013 and December 31, 2012 and included in accumulated other comprehensive income (loss) amounted to $(2.6) million and $12.9 million, net of deferred taxes of $(1.4) million and $7.0 million, respectively.

Impaired Securities

Management periodically reviews the Company's investment portfolio to determine the cause, magnitude and duration of declines in the fair value of each security. Thorough evaluations of the causes of the unrealized losses are performed to determine whether the impairment is temporary or other-than-temporary in nature. Considerations such as the ability of the securities to meet cash flow requirements, levels of credit enhancements, risk of curtailment, recoverability of invested amount over a reasonable period of time and the length of time the security is in a loss position, for example, are applied in determining other-than-temporary impairment ("OTTI"). Once a decline in value is determined to be other-than-temporary, the value of the security is reduced and a corresponding charge to earnings is recognized.

The following table presents the estimated fair values and gross unrealized losses of investment securities that were in a continuous loss position at June 30, 2013 and December 31, 2012, by length of time that individual securities in each category have been in a continuous loss position:

	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
June 30, 2013						
Mortgage-backed securities	$171,566	$(5,401)	$—	$—	$171,566	$(5,401)
Collateralized mortgage obligations	298,708	(7,840)	—	—	298,708	(7,840)
Private issue collateralized mortgage obligations	139	(5)	5,985	(268)	6,124	(273)
Total	$470,413	$(13,246)	$5,985	$(268)	$476,398	$(13,514)
December 31, 2012						
Mortgage-backed securities	$42,782	$(79)	$—	$—	$42,782	$(79)
Collateralized mortgage obligations	73,098	(120)	—	—	73,098	(120)
Private issue collateralized mortgage obligations	—	—	8,174	(697)	8,174	(697)
Total	$115,880	$(199)	$8,174	$(697)	$124,054	$(896)

At June 30, 2013, the Company held $476.4 million in investment securities with unrealized losses that are considered temporary. Included in the unrealized losses were non-agency private issue collateralized mortgage obligations ("non-agency"). At June 30, 2013, the Company held $7.8 million in non-agencies of which $6.0 million had unrealized losses for twelve months or longer. Management believes the unrealized losses for the non-agencies are the result of current market conditions and the underestimation of their value in the market. Management currently has the intent and ability to retain these investment securities with unrealized losses until the decline in value has been recovered. Stress tests are performed monthly on the non-agencies, which are higher risk bonds, within the investment portfolio using current statistical data to determine expected cash flows and forecast potential losses. The results of the stress tests during the first six months of 2013 indicated potential future credit losses that were lower than previously recorded OTTI and as such no additional OTTI was recorded during the second quarter of 2013.

Security Gains and Losses and Other-Than-Temporary Impairment of Securities

The following tables details the Company's sales of investment securities, the gross realized gains and losses, and impairment of securities:

	Three Months Ended June 30,		Six Months Ended June 30,	
Available-for-sale	2013	2012	2013	2012
Proceeds from sales of securities	$—	$18,324	$4,875	$31,364
Gross realized gains	—	951	138	1,104
Gross realized (losses)	—	(200)	—	(203)
Other-than-temporary impairment of securities	—	—	—	(29)

During the first six months of 2013, the Company sold certain investment securities with a total carrying value of $4.9 million in order to manage its liquidity and interest rate risk. The securities that were sold were primarily selected based on an assessment of their prepayment speed and did not have any recorded OTTI.

Securities Pledged

At June 30, 2013 and December 31, 2012, securities with an amortized cost of $440.1 million and $465.0 million and a fair value of $443.1 million and $482.4 million, respectively, were pledged to secure Federal Home Loan Bank ("FHLB") advances, public deposits, and securities sold under agreements to repurchase and for other purposes required or permitted by law.

Contractual Maturities
The amortized cost and estimated fair values of debt securities by contractual maturity at June 30, 2013, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

Available-for-sale	Amortized Cost	Fair Value
Due in one year or less	$1,881	$1,924
Due after one year through five years	25,541	26,278
Due after five years through ten years	129,625	130,554
Due after ten years	636,306	630,613
	$793,353	$789,369

NOTE 4 – LOANS AND ALLOWANCE FOR LOAN LOSSES

The composition of the Company's loan portfolio, excluding residential loans held for sale, at June 30, 2013 and December 31, 2012 was as follows:

	June 30, 2013	December 31, 2012
Residential real estate loans	$570,011	$572,768
Commercial real estate loans	522,987	506,231
Commercial loans	190,068	190,454
Home equity loans	301,868	278,375
Consumer loans	18,115	16,633
Deferred loan fees net of costs	(490)	(595)
Total loans	$1,602,559	$1,563,866

The Company's lending activities are primarily conducted in Maine. The Company originates single family and multi-family residential loans, commercial real estate loans, business loans, municipal loans and a variety of consumer loans. In addition, the Company makes loans for the construction of residential homes, multi-family properties and commercial real estate properties. The ability and willingness of borrowers to honor their repayment commitments is generally dependent on the level of overall economic activity within the geographic area and the general economy. During the first six months of 2013 and 2012, the Company sold $19.8 million and $18.8 million, respectively, of fixed-rate residential mortgage loans on the secondary market that resulted in net gains on the sale of loans of $652,000 and $268,000, respectively.

In connection with a branch acquisition in 2012, the Company acquired $6.0 million in performing commercial loans. The loans were recorded at fair value, which was determined by estimating the amount and timing of principal and interest cash flows expected to be collected on the loans and discounting those cash flows at a market rate of interest. As a result of this analysis, the Company recorded a fair value mark of $317,000, which will amortize over the estimated lives of the loans. Additionally, the acquired loans did not have any related allowance for loan losses ("ALL") as they were recorded at fair value; however, an ALL will be established should the credit quality of these loans deteriorate subsequent to the acquisition. Based on the immateriality of the acquired loans and fair value mark, additional disclosures related to the acquired loans are not required.

The ALL is management's best estimate of the inherent risk of loss in the Company's loan portfolio as of the statement of condition date. Management makes various assumptions and judgments about the collectability of the loan portfolio and provides an allowance for potential losses based on a number of factors including historical losses. If those assumptions are incorrect, the ALL may not be sufficient to cover losses and may cause an increase in the allowance in the future. Among the factors that could affect the Company's ability to collect loans and require an increase to the ALL in the future are: general real estate and economic conditions; regional credit concentration; industry concentration, for example in the hospitality, tourism and recreation industries; and a requirement by federal and state regulators to increase the provision for loan losses or recognize additional charge-offs.

The board of directors monitors credit risk management through the Directors' Loan Committee and the Corporate Risk Management group. The Directors' Loan Committee reviews large exposure credit requests, monitors asset quality on a regular basis and has approval authority for credit granting policies. The Corporate Risk Management group oversees management's systems and procedures to monitor the credit quality of the loan portfolio, conduct a loan review program, maintain the integrity of the loan rating system and determine the adequacy of the ALL. The Company's practice is to identify problem credits early and take charge-offs as promptly as practicable. In addition, management continuously reassesses its underwriting standards in response to credit risk posed by changes in economic conditions. For purposes of determining the ALL, the Company disaggregates its portfolio loans into portfolio segments, which include residential real estate, commercial real estate, commercial, home equity, and consumer.

The following table presents activity in the ALL for the three months ended June 30, 2013:

	Residential Real Estate	Commercial Real Estate	Commercial	Home Equity	Consumer	Unallocated	Total
ALL:							
Beginning balance	$7,269	$ 3,602	$6,200	$3,358	$222	$2,718	$23,369
Loans charged off	(202)	(91)	(167)	(309)	(76)	—	(845)
Recoveries	2	17	69	—	9	—	97
Provision (reduction)	(837)	62	(314)	379	66	1,344	700
Ending balance	$6,232	$ 3,590	$5,788	$3,428	$221	$4,062	$23,321

The following table presents activity in the ALL for the six months ended June 30, 2013:

	Residential Real Estate	Commercial Real Estate	Commercial	Home Equity	Consumer	Unallocated	Total
ALL:							
Beginning balance	$6,996	$ 4,549	$5,933	$2,520	$184	$2,862	$23,044
Loans charged off	(347)	(171)	(444)	(337)	(133)	—	(1,432)
Recoveries	5	92	198	2	28	—	325
Provision (reduction)	(422)	(880)	101	1,243	142	1,200	1,384
Ending balance	$6,232	$ 3,590	$5,788	$3,428	$221	$4,062	$23,321
ALL balance attributable to loans:							
Individually evaluated for impairment	$1,487	$ 296	$386	$442	$71	$—	$2,682
Collectively evaluated for impairment	4,745	3,294	5,402	2,986	150	4,062	20,639
Total ending ALL	$6,232	$ 3,590	$5,788	$3,428	$221	$4,062	$23,321
Loans:							
Individually evaluated for impairment	$12,099	$ 8,479	$3,612	$1,526	$421	$—	$26,137
Collectively evaluated for impairment	557,422	514,508	186,456	300,342	17,694	—	1,576,422
	$569,521	$ 522,987	$190,068	$301,868	$18,115	$—	$1,602,559

Total ending loans balance

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The following table presents activity in the ALL for the three months ended June 30, 2012:

	Residential Real Estate	Commercial Real Estate	Commercial	Home Equity	Consumer	Unallocated	Total
ALL:							
Beginning balance	$6,103	$5,713	$5,193	$2,474	$523	$3,004	$23,010
Loans charged off	(138)	(30)	(225)	(464)	(4)	—	(861)
Recoveries	63	145	56	20	3	—	287
Provision (reduction)	324	(991)	1,344	289	(358)	218	826
Ending balance	$6,352	$4,837	$6,368	$2,319	$164	$3,222	$23,262

The following table presents activity in the ALL for the six months ended June 30, 2012:

	Residential Real Estate	Commercial Real Estate	Commercial	Home Equity	Consumer	Unallocated	Total
ALL:							
Beginning balance	$6,398	$5,702	$4,846	$2,704	$420	$2,941	$23,011
Loans charged off	(446)	(209)	(416)	(851)	(28)	—	(1,950)
Recoveries	68	166	120	20	10	—	384
Provision (reduction)	332	(822)	1,818	446	(238)	281	1,817
Ending balance	$6,352	$4,837	$6,368	$2,319	$164	$3,222	$23,262
ALL balance attributable to loans:							
Individually evaluated for impairment	$1,903	$707	$933	$203	$39	$—	$3,785
Collectively evaluated for impairment	4,449	4,130	5,435	2,116	125	3,222	19,477
Total ending ALL	$6,352	$4,837	$6,368	$2,319	$164	$3,222	$23,262
Loans:							
Individually evaluated for impairment	$13,458	$7,362	$4,751	$1,651	$263	$—	$27,485
Collectively evaluated for impairment	556,365	489,049	177,677	270,658	15,230	—	1,508,979
Total ending loans balance	$569,823	$496,411	$182,428	$272,309	$15,493	$—	$1,536,464

The following table presents the activity in the ALL for the year ended December 31, 2012:

	Residential Real Estate	Commercial Real Estate	Commercial	Home Equity	Consumer	Unallocated	Total
ALL:							
Beginning balance	$6,398	$5,702	$4,846	$2,704	$420	$2,941	$23,011
Loans charged off	(1,197)	(593)	(1,393)	(1,234)	(85)	—	(4,502)
Recoveries	73	222	406	23	20	—	744
Provision (reduction)	1,722	(782)	2,074	1,027	(171)	(79)	3,791
Ending balance	$6,996	$4,549	$5,933	$2,520	$184	$2,862	$23,044
ALL balance attributable to loans:							
Individually evaluated for impairment	$2,255	$265	$286	$261	$39	$—	$3,106
Collectively evaluated for impairment	4,741	4,284	5,647	2,259	145	2,862	19,938
Total ending ALL	$6,996	$4,549	$5,933	$2,520	$184	$2,862	$23,044

Loans:							
Individually evaluated for impairment	$13,805	$7,968	$3,610	$1,515	$259	$—	$27,157
Collectively evaluated for impairment	558,368	498,263	186,844	276,860	16,374	—	1,536,709
Total ending loans balance	$572,173	$506,231	$190,454	$278,375	$16,633	$—	$1,563,866

The ALL for the Company’s portfolio segments is determined based on loan balances and the historical performance factor of each portfolio segment. The significant changes in the ALL for the first six months ended June 30, 2013, compared to the year ended December 31, 2012, were within the home equity and commercial real estate portfolio segments. The increase in the allocation of ALL for home equity was primarily due to the 8.4% increase in loan balances and its historical performance, while the decrease in commercial real estate allocation was due to the improvement in that segment's performance factor.

The Company focuses on maintaining a well-balanced and diversified loan portfolio. Despite such efforts, it is recognized that credit concentrations may occasionally emerge as a result of economic conditions, changes in local demand, natural loan growth and runoff. To ensure that credit concentrations can be effectively identified, all commercial and commercial real estate loans are assigned Standard Industrial Classification codes, North American Industry Classification System codes, and state and county codes. Shifts in portfolio concentrations are monitored by the Credit Risk Policy Committee. As of June 30, 2013, the two most significant industry exposures within the commercial real estate loan portfolio were non-residential building operators (operators of commercial and industrial buildings, retail establishments, theaters, banks and insurance buildings) and lodging (inns, bed & breakfasts, ski lodges, tourist cabins, hotels and motels). At June 30, 2013, exposure to these two industries as a percentage of total commercial real estate loans, was 29% and 23%, respectively.

To further identify loans with similar risk profiles, the Company categorizes each portfolio segment into classes by credit risk characteristic and applies a credit quality indicator to each portfolio segment. The indicators for commercial, commercial real estate and residential real estate loans are represented by Grades 1through 10 as outlined below. In general, risk ratings are adjusted periodically throughout the year as updated analysis and review warrants. This process may include, but is not limited to, annual credit and loan reviews, periodic reviews of loan performance metrics, such as delinquency rates, and quarterly reviews of adversely risk rated loans. The Company uses the following definitions when assessing grades for the purpose of evaluating the risk and adequacy of the ALL:

- Grade 1 through 6 — Grades 1through 6 represent groups of loans that are not subject to adverse criticism as defined in regulatory guidance. Loans in these groups exhibit characteristics that represent low to moderate risks, which is measured using a variety of credit risk criteria, such as cash flow coverage, debt service coverage, balance sheet leverage, liquidity, management experience, industry position, prevailing economic conditions, support from secondary sources of repayment and other credit factors that may be relevant to a specific loan. In general, these loans are supported by properly margined collateral and guarantees of principal parties.
- Grade 7 — Loans with potential weakness (Special Mention). Loans in this category are currently protected based on collateral and repayment capacity and do not constitute undesirable credit risk, but have potential weakness that may result in deterioration of the repayment process at some future date. This classification is used if a negative trend is evident in the obligor’s financial situation. Special mention loans do not sufficiently expose the Company to warrant adverse classification.
- Grade 8 — Loans with definite weakness (Substandard). Loans classified as substandard are inadequately protected by the current sound worth and paying capacity of the obligor or by collateral pledged. This classification is used if borrowers experience difficulty in meeting debt repayment requirements. Deterioration is sufficient to cause the Company to look to the sale of collateral.
- Grade 9 — Loans with potential loss (Doubtful). Loans classified as doubtful have all the weaknesses inherent in the substandard grade with the added characteristic that the weaknesses make collection or liquidation of the loan in full highly questionable and improbable. The possibility of some loss is extremely high, but because of specific pending factors that may work to the advantage and strengthening of the asset, its classification as an estimated loss is deferred until its more exact status may be determined.
- Grade 10 — Loans with definite loss (Loss). Loans classified as loss are considered uncollectible. The loss classification does not mean that the asset has absolutely no recovery or salvage value, but rather that it is not practical or desirable to defer writing off the asset because recovery and collection time may be protracted.

Asset quality indicators are periodically reassessed to appropriately reflect the risk composition of the Company’s loan portfolio. Home equity and consumer loans are not individually risk rated, but rather analyzed as groups taking into account delinquency rates and other economic conditions which may affect the ability of borrowers to meet debt service requirements, including interest rates and energy costs. Performing loans include loans that are current and loans that are past due less than 90 days. Loans that are past due over 90 days and non-accrual loans are considered non-performing.

The following table summarizes credit risk exposure indicators by portfolio segment as of the following dates:

	Residential Real Estate	Commercial Real Estate	Commercial	Home Equity	Consumer
June 30, 2013					
Pass (Grades 1-6)	$553,040	$465,947	$169,208	$—	$—
Performing	—	—	—	300,343	17,695
Special Mention (Grade 7)	2,771	13,400	7,919	—	—
Substandard (Grade 8)	13,710	43,640	12,941	—	—
Non-performing	—	—	—	1,525	420
Total	$569,521	$522,987	$190,068	$301,868	$18,115
December 31, 2012					
Pass (Grades 1-6)	$555,444	$440,610	$165,460	$—	$—
Performing	—	—	—	276,742	16,376
Special Mention (Grade 7)	1,291	17,069	7,449	—	—
Substandard (Grade 8)	15,438	48,552	17,545	—	—
Non-performing	—	—	—	1,633	257
Total	$572,173	$506,231	$190,454	$278,375	$16,633

The Company closely monitors the performance of its loan portfolio. Loans past due 30 days or more are considered delinquent. In general, consumer loans will be charged off if the loan is delinquent for 90 consecutive days. Commercial and real estate loans may be charged off in part or in full if they appear uncollectible. A loan is placed on non-accrual status when the financial condition of the borrower is deteriorating, payment in full of both principal and interest is not expected as scheduled or principal or interest has been in default for 90 days or more. Exceptions may be made if the asset is well-secured by collateral sufficient to satisfy both the principal and accrued interest in full and collection is assured by a specific event, such as the closing of a pending sale contract. When one loan to a borrower is placed on non-accrual status, generally all other loans to the borrower are re-evaluated to determine if they should also be placed on non-accrual status. All previously accrued and unpaid interest is reversed at this time. Interest payments received on non-accrual loans (including impaired loans) are applied as a reduction of principal. A loan remains on non-accrual status until all principal and interest amounts contractually due are brought current and future payments are reasonably assured. A loan may be returned to accrual status when collection of principal and interest is assured and the borrower has demonstrated timely payments of principal and interest for a reasonable period. Unsecured loans, however, are not normally placed on non-accrual status because they are charged-off once their collectability is in doubt.

The following is a loan aging analysis by portfolio segment (including loans past due over 90 days and non-accrual loans) and a summary of non-accrual loans, which include troubled debt restructured loans ("TDRs"), and loans past due over 90 days and accruing as of the following dates:

	30-59 Days Past Due	60-89 Days Past Due	Greater than 90 Days	Total Past Due	Current	Total Loans Outstanding	Loans > 90 Days Past Due and Accruing	Non-Accrual Loans
June 30, 2013								
Residential real estate	$1,466	$671	$6,857	$8,994	$560,527	$569,521	$—	$ 8,624
Commercial real estate	1,916	337	4,853	7,106	515,881	522,987	—	6,634
Commercial	383	87	2,637	3,107	186,961	190,068	—	3,233
Home equity	527	57	1,113	1,697	300,171	301,868	—	1,525
Consumer	181	41	394	616	17,499	18,115	—	420
Total	$4,473	$1,193	$15,854	$21,520	$1,581,039	$1,602,559	$—	$ 20,436
December 31, 2012								
Residential real estate	$1,459	$850	$8,410	$10,719	$561,454	$572,173	$193	$ 10,584
Commercial real estate	896	2,227	5,380	8,503	497,728	506,231	138	6,719
Commercial	1,079	68	2,969	4,116	186,338	190,454	160	3,409
Home equity	2,230	355	1,105	3,690	274,685	278,375	118	1,514
Consumer	342	199	259	800	15,833	16,633	2	257
Total	$6,006	$3,699	$18,123	$27,828	$1,536,038	$1,563,866	$611	$ 22,483

The Company takes a conservative approach in credit risk management and remains focused on community lending and reinvesting. The Company's Credit Administration group works closely with borrowers experiencing credit problems to assist in loan repayment or term modifications. TDRs consist of loans where the Company, for economic or legal reasons related to the borrower's financial difficulties, granted a concession to the borrower that it would not otherwise consider. TDRs involve term modifications or a reduction of either interest or principal. Once such an obligation has been restructured, it will continue to remain in a restructured status until paid in full.

At June 30, 2013 and December 31, 2012, the allowance related to TDRs was $552,000 and $494,000, respectively. The specific reserve component was determined by discounting the total expected future cash flows from the borrower, or if the loan is currently collateral-dependent, using the fair value of the underlying collateral, which was obtained through independent appraisals and internal evaluations. At June 30, 2013, the Company did not have any commitments to lend additional funds to borrowers with loans classified as TDRs.

During the first six months of 2013, the Company modified seven loans as TDRs, which had current balances of $872,000 at June 30, 2013. During the first six months of 2012, the Company did not modify any loans as TDRs. The modification of these loans as TDRs did not have a material financial effect on the Company. Loans restructured due to credit difficulties that are now performing were $5.7 million at June 30, 2013 and $4.7 million at December 31, 2012. The Company did not have any TDRs that subsequently defaulted during the first six months of 2013 and 2012.

The following is a summary of accruing and non-accruing TDRs by portfolio segment as of the following dates:

	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Current Balance
June 30, 2013				
Residential real estate	22	$471	$471	$412
Commercial real estate	9	2,844	2,897	2,714
Commercial	6	3,581	3,719	3,540
Consumer	1	3	3	1
Total	38	$6,899	$7,090	$6,667
December 31, 2012				
Residential real estate	20	$3,305	$3,434	$3,286
Commercial real estate	6	2,602	2,649	2,344
Commercial	3	303	303	236
Consumer	1	3	3	2
Total	30	$6,213	$6,389	$5,868

Impaired loans consist of non-accrual loans and TDRs. The following is a summary of impaired loan balances and associated allowance by portfolio segment as of the following dates and for the periods then ended:

				Three Months Ended		Six Months Ended	
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
June 30, 2013							
With an allowance recorded:							
Residential real estate	$9,491	$9,491	$1,487	$9,250	$30	$9,967	$59
Commercial real estate	4,047	4,047	296	4,082	6	4,213	9
Commercial	2,754	2,754	386	2,749	1	2,779	3
Home equity	1,243	1,243	442	1,148	—	1,338	—
Consumer	420	420	71	461	—	459	—
Ending Balance	$17,955	$17,955	$2,682	$17,690	$37	$18,756	$71
Without allowance recorded:							
Residential real estate	$2,608	$3,503	$—	$2,874	$6	$2,954	$13
Commercial real estate	4,432	4,705	—	4,072	24	3,794	46
Commercial	858	981	—	652	5	595	6
Home equity	283	483	—	412	—	388	—
Consumer	1	1	—	2	—	2	—
Ending Balance	$8,182	$9,673	$—	$8,012	$35	$7,733	$65
Total impaired loans	$26,137	$27,628	$2,682	$25,702	$72	$26,489	$136

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Year Ended Average Recorded Investment	Interest Income Recognized
December 31, 2012					
With related allowance recorded:					
Residential real estate	$11,021	$11,021	$2,255	$10,585	$114
Commercial real estate	4,296	4,296	265	5,551	—
Commercial	2,971	2,971	286	3,927	—
Home equity	1,236	1,236	261	1,289	—
Consumer	257	257	39	239	—
Ending Balance	$19,781	$19,781	$3,106	$21,591	$114
Without related allowance recorded:					
Residential real estate	$2,784	$3,841	$—	$2,548	$26
Commercial real estate	3,672	4,127	—	2,056	33
Commercial	639	956	—	389	13
Home equity	279	550	—	617	—
Consumer	2	2	—	6	—
Ending Balance	$7,376	$9,476	$—	$5,616	$72
Total impaired loans	$27,157	$29,257	$3,106	$27,207	$186

NOTE 5 – GOODWILL, CORE DEPOSIT AND TRUST RELATIONSHIP INTANGIBLES

The Company has recognized goodwill and certain identifiable intangible assets in connection with certain acquisitions of other businesses in prior years. The changes in goodwill, core deposit intangible and trust relationship intangible for the six months ended June 30, 2013 are shown in the table below:

	Goodwill		
	Banking	Financial Services	Total
Balance at December 31, 2012	$40,902	$6,734	$47,636
2013 activity	—	—	—
Balance at June 30, 2013	$40,902	$6,734	$47,636

	Core Deposit Intangible			Trust Relationship Intangible		
	Total	Accumulated Amortization	Net	Total	Accumulated Amortization	Net
Balance at December 31, 2012	$17,300	$(12,014)	$5,286	$753	$(376)	$377
2013 amortization	—	(536)	(536)	—	(38)	(38)
Balance at June 30, 2013	$17,300	$(12,550)	$4,750	$753	$(414)	$339

The following table reflects the expected amortization schedule for intangible assets at June 30, 2013:

	Core Deposit Intangible	Trust Relationship Intangible
2013	$788	$38
2014	1,073	75
2015	1,073	75
2016	1,073	75
2017	743	76
Total unamortized intangible assets	$4,750	$339

NOTE 6 – EMPLOYEE BENEFIT PLANS

The Company maintains an unfunded, non-qualified supplemental executive retirement plan for certain officers and provides medical and life insurance to certain eligible retired employees. The components of net period benefit cost for the periods ended June 30, 2013 and 2012 were as follows:

Supplemental Executive Retirement Plan

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Net period benefit cost				
Service cost	$82	$67	$164	$134
Interest cost	94	102	188	204
Recognized net actuarial loss	56	29	112	58
Recognized prior service cost	5	5	10	10
Net period benefit cost	$237	$203	$474	$406

Other Postretirement Benefit Plan

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Net period benefit cost				
Service cost	$19	$17	$38	$34
Interest cost	35	37	70	74
Recognized net actuarial loss	11	8	22	16
Net period benefit cost	$65	$62	$130	$124

NOTE 7 – STOCK-BASED COMPENSATION PLANS

On February 26, 2013, the Company granted 6,325 restricted stock awards to certain officers of the Company and its subsidiaries under the 2012 Equity and Incentive Plan. The holders of these awards participate fully in the rewards of stock ownership of the Company, including voting and dividend rights. The restricted stock awards have been determined to have a fair value of $33.72 per unit, based on the market price of the Company’s common stock on the date of grant. The restricted stock awards vest over a three-year period.

Under the Long-term Performance Share Plan, 6,797 shares vested upon the achievement of certain revenue and expense goals under the 2010-2012 Long-term Performance Share Plan metrics and 4,352 shares, net of taxes, were issued to participants.

Under the Management Stock Purchase Plan, 7,801 shares were purchased by employees at a discount in lieu of the management employees' annual incentive bonus during the first three months of 2013. During the first quarter of 2013, the Company granted 2,304 deferred stock awards under the Defined Contribution Retirement Plan.

On March 26, 2013, the Company approved the Amended and Restated Long-Term Performance Share Plan for the 2013 – 2015 performance period (the "2013 – 2015 LTIP"). Pursuant to the 2013 – 2015 LTIP, certain executive officers of the Company are eligible to receive equity compensation based on the attainment of certain performance goals set forth in the 2013 – 2015 LTIP. Performance goals under the 2013-2015 LTIP include specific revenue growth and efficiency ratio goals for threshold, target and superior levels of performance, and a minimum level of performance for the Company's non-performing asset to total asset ratio at December 31, 2015 and a minimum level of net income growth for the three-year period ending December 31, 2015.

NOTE 8 – FAIR VALUE MEASUREMENT AND DISCLOSURE

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value is best determined using quoted market prices. However, in many instances, quoted market prices are not available. In such instances, fair values are determined using various valuation techniques. Various assumptions and observable inputs must be relied upon in applying these techniques. GAAP 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.

GAAP permits an entity to choose to measure eligible financial instruments and other items at fair value. The Company has elected the fair value option for its loans held for sale. Electing the fair value option for loans held for sale enables the Company's financial position to more clearly align with the economic value of the actively traded asset.

The fair value hierarchy for valuation of an asset or liability is as follows:

Level 1: Valuation is based upon unadjusted quoted prices in active markets for identical assets and liabilities that the entity has the ability to access as of the measurement date.

Level 2: Valuation is determined from quoted prices for similar assets or liabilities in active markets, from quoted prices for identical or similar instruments in markets that are not active or by model-based techniques in which all significant inputs are observable in the market.

Level 3: Valuation is derived from model-based and other techniques in which at least one significant input is unobservable and which may be based on the Company's own estimates about the assumptions that market participants would use to value the asset or liability.

In general, fair value is based upon quoted market prices, where available. If such quoted market prices are not available, fair value is based upon model-based techniques incorporating various assumptions including interest rates, prepayment speeds and credit losses. Assets and liabilities valued using model-based techniques are classified as either Level 2 or Level 3, depending on the lowest level classification of an input that is considered significant to the overall valuation. A description of the valuation methodologies used for instruments measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy, is set forth below.

Financial Instruments Recorded at Fair Value on a Recurring Basis

Securities Available-for-sale: The fair value of debt securities available-for-sale is reported utilizing prices provided by an independent pricing service based on recent trading activity and other observable information including, but not limited to, dealer quotes, market spreads, cash flows, market interest rate curves, market consensus prepayment speeds, credit information, and the bond's terms and conditions. The fair value of equity securities available-for-sale was calculated using a discounted cash flow analysis using observable information including, but not limited to, cash flows, risk-adjusted discount rates and market spreads. The fair values of debt and equity securities are classified as Level 2.

Trading Account Assets: Trading account assets are invested in mutual funds and classified as Level 1 based upon quoted prices.

Loans Held for Sale: The fair value of loans held for sale is determined using quoted secondary market prices or executed sales agreements and classified as Level 2.

Derivatives: The fair value of interest rate swaps is determined using inputs that are observable in the market place obtained from third parties including yield curves, publicly available volatilities, and floating indexes and, accordingly, are classified as Level 2 inputs. The credit value adjustments associated with derivatives utilize Level 3 inputs, such as estimates of current credit spreads to evaluate the likelihood of default by the Company and its counterparties. As of June 30, 2013 and December 31, 2012, the Company has assessed the significance of the impact of the credit valuation adjustments on the overall valuation of its derivative positions and has determined that the credit valuation adjustments are not significant to the overall valuation of its derivatives due to collateral postings.

The following table summarizes financial assets and financial liabilities measured at fair value on a recurring basis as of June 30, 2013 and December 31, 2012, segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure fair value:

	Readily Available Market Prices (Level 1)	Observable Market Data (Level 2)	Company Determined Fair Value (Level 3)	Total
June 30, 2013				
Financial Assets:				
Available-for-sale debt securities:				
Obligations of states and political subdivisions	$—	$30,489	$—	$30,489
Mortgage-backed securities issued or guaranteed by U.S. government sponsored enterprises	—	348,778	—	348,778
Collateralized mortgage obligations issued or guaranteed by U.S. government sponsored enterprises	—	402,257	—	402,257
Private issue collateralized mortgage obligations	—	7,845	—	7,845
Trading account assets	2,281	—	—	2,281
Loans held for sale	—	2,826	—	2,826
Customer interest rate swap agreements	—	193	—	193
Financial Liabilities:				
Interest rate swap agreements	—	6,437	—	6,437
December 31, 2012				
Financial Assets:				
Available-for-sale debt securities:				
Obligations of states and political subdivisions	$—	$33,040	$—	$33,040
Mortgage-backed securities issued or guaranteed by U.S. government sponsored enterprises	—	358,148	—	358,148
Collateralized mortgage obligations issued or guaranteed by U.S. government sponsored enterprises	—	381,688	—	381,688
Private issue collateralized mortgage obligations	—	8,174	—	8,174
Trading account assets	2,300	—	—	2,300
Customer interest rate swap agreements	—	496	—	496
Financial Liabilities:				
Interest rate swap agreements	—	11,580	—	11,580

The Company did not have any transfers between Level 1 and Level 2 of the fair value hierarchy during the six months ended June 30, 2013. The Company's policy for determining transfers between levels occurs at the end of the reporting period when circumstances in the underlying valuation criteria change and result in transfer between levels.

Financial Instruments Recorded at Fair Value on a Nonrecurring Basis

The Company may be required, from time to time, to measure certain financial assets and financial liabilities at fair value on a nonrecurring basis in accordance with GAAP. These include assets that are measured at the lower of cost or market value that were recognized at fair value below cost at the end of the period.

Collateral-Dependent Impaired Loans: Loans for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan agreement are considered impaired. Once a loan is identified as individually impaired, the Company measures impairment in accordance with GAAP. Impaired loans are measured using one of three methods: the present value of expected future cash flows discounted at the loan’s effective interest rate; the loan’s observable market price; or the fair value of the collateral if the loan is collateral dependent. If the measure is less than an impaired loan’s recorded investment, an impairment loss is recognized as part of the ALL. Accordingly, certain impaired loans may be subject to measurement at fair value on a non-recurring basis. Management has estimated the fair values of these assets using Level 2 inputs, such as the fair value of collateral based on independent third-party market approach appraisals for collateral-dependent loans, and level 3 inputs where circumstances warrant an adjustment to the appraised value based on the age of the appraisal and/or comparable sales, condition of the collateral, and market conditions.

Mortgage Servicing Rights: The Company accounts for mortgage servicing assets at cost, subject to impairment testing. When the carrying value exceeds fair value, a valuation allowance is established to reduce the carrying cost to fair value. Fair value is based on a valuation model that calculates the present value of estimated net servicing income. The Company obtains a third-party valuation based upon loan level data including note rate, type and term of the underlying loans. The model utilizes a variety of observable inputs for its assumptions, the most significant of which are loan prepayment assumptions and the discount rate used to discount future cash flows. Other assumptions include delinquency rates, servicing cost inflation and annual unit loan cost. Mortgage servicing rights are classified within Level 2 of the fair value hierarchy.

Non-Financial Assets and Non-Financial Liabilities Recorded at Fair Value

The Company has no non-financial assets or non-financial liabilities measured at fair value on a recurring basis. Non-financial assets measured at fair value on a non-recurring basis consist of other real estate owned (“OREO”).

OREO properties acquired through foreclosure or deed in lieu of foreclosure are recorded at the fair value of the real estate, less costs to sell. Any write-down of the recorded investment in the related loan is charged to the allowance for loan losses upon transfer to OREO. Upon acquisition of a property, a current appraisal or a broker’s opinion is used to substantiate fair value for the property. After foreclosure, management periodically obtains updated valuations of the OREO assets and, if additional impairments are deemed necessary, the subsequent write-downs for declines in value are recorded through a valuation allowance and a provision for losses charged to other non-interest expense. Certain assets require assumptions, such as expected future cash flows, that are not observable in an active market in determination of fair value and are classified as Level 3.

Assets measured at fair value on a non-recurring basis as of June 30, 2013 and December 31, 2012 are included below:

	Readily Available Market Prices (Level 1)	Observable Market Data (Level 2)	Company Determined Fair Value (Level 3)	Total
June 30, 2013				
Assets:				
Collateral-dependent impaired loans	$—	$—	$7,998	$7,998
Other real estate owned	—	—	2,155	2,155
Mortgage servicing rights	—	1,316	—	1,316
December 31, 2012				
Assets:				
Collateral-dependent impaired loans	$—	$—	$9,183	$9,183
Other real estate owned	—	—	1,313	1,313
Mortgage servicing rights	—	879	—	879

The following table presents the valuation methodology and unobservable inputs for Level 3 assets measured at fair value on a non-recurring basis at June 30, 2013:

	Fair Value	Valuation Methodology	Unobservable input	Discount Range	
June 30, 2013					
Collateral-dependent impaired loans: (1)					
Partially charged-off	$3,378	Market approach appraisal of collateral	Management adjustment of appraisal	10 – 30	%
Specifically reserved	$4,620	Market approach appraisal of collateral	Management adjustment of appraisal	—	(2)
Other real estate owned	$2,155	Market approach appraisal of collateral	Management adjustment of appraisal	10 – 30	%
			Estimated selling cost	6 – 10	%
December 31, 2012					
Collateral-dependent impaired loans:(1)					
Partially charged-off	$3,524	Market approach appraisal of collateral	Management adjustment of appraisal	10 – 30	%
Specifically reserved	$5,659	Market approach appraisal of collateral	Management adjustment of appraisal	—	(2)
Other real estate owned	$1,313	Market approach appraisal of collateral	Management adjustment of appraisal	10 – 30	%
			Estimated selling cost	6 – 10	%

(1) Does not include impaired loans that are measured by the present value of expected future cash flows discounted at the loan's effective interest rate.

(2) The specific reserve for collateral-dependent impaired loans is determined by any deficit of 75% of collateral value over the recorded investment.

GAAP requires disclosure of the fair value of financial assets and financial liabilities, including those financial assets and financial liabilities that are not measured and reported at fair value on a recurring basis or non-recurring basis. The methodologies for estimating the fair value of financial assets and financial liabilities that are measured at fair value on a recurring or non-recurring basis are discussed above. The following methods and assumptions were used by the Company in estimating the fair values of its other financial instruments.

Cash and Due from Banks: The carrying amounts reported in the consolidated statement of condition approximate fair value.

FHLB and Federal Reserve Bank Stock and Investments in Trust Preferred Securities Affiliates: The carrying amounts reported in the consolidated statements of condition approximate fair value.

Loans: For variable rate loans that reprice frequently and have no significant change in credit risk, fair values are based on carrying values. The fair value of other loans is estimated by discounting the future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities.

Interest Receivable and Payable: The carrying amounts reported in the consolidated statements of condition approximate fair value.

Deposits: The fair value of deposits with no stated maturity is equal to the carrying amount. The fair value of certificates of deposit is estimated using a discounted cash flow calculation that applies interest rates and remaining maturities for currently offered certificates of deposit.

Borrowings: The carrying amounts of short-term borrowings from the FHLB, securities sold under repurchase agreements, notes payable and other short-term borrowings approximate fair value. The fair values of long-term borrowings and commercial repurchase agreements are based on the discounted cash flows using current rates for advances of similar remaining maturities.

Junior Subordinated Debentures: The carrying amounts reported in the consolidated statements of condition approximate fair value.

The following table presents the carrying amounts and estimated fair value for financial instrument assets and liabilities measured at June 30, 2013:

	Carrying Amount	Fair Value	Readily Available Market Prices (Level 1)	Observable Market Prices (Level 2)	Company Determined Market Prices (Level 3)
Financial assets:					
Cash and due from banks	$44,896	$44,896	$44,896	$—	$—
Securities available-for-sale	789,369	789,369	—	789,369	—
FHLB and Federal Reserve Bank stock	19,724	19,724	19,724	—	—
Trading account assets	2,281	2,281	2,281	—	—
Loans held for sale	2,826	2,826	—	2,826	—
Residential real estate loans	561,975	575,594	—	—	575,594
Commercial real estate loans	518,640	508,194	—	—	508,194
Commercial loans	183,059	180,642	—	—	180,642
Home equity loans	297,717	296,968	—	—	296,968
Consumer loans	17,847	18,104	—	—	18,104
Mortgage servicing rights	774	1,316	—	1,316	—
Interest receivable	6,506	6,506	—	6,506	—
Investment in trust preferred securities affiliates	1,331	1,331	—	—	1,331
Customer interest rate swap agreements	193	193	—	193	—
Financial liabilities:					
Deposits	1,894,087	1,899,346	1,340,252	559,094	—
FHLB advances	186,147	189,421	—	189,421	—
Commercial repurchase agreements	30,165	32,615	—	32,615	—
Other borrowed funds	188,153	188,153	188,153	—	—
Junior subordinated debentures	43,870	43,845	—	43,845	—
Interest payable	563	563	563	—	—
Interest rate swap agreements	6,437	6,437	—	6,437	—

The following table presents the carrying amounts and estimated fair value for financial instrument assets and liabilities measured at December 31, 2012:

	Carrying Amount	Fair Value	Readily Available Market Prices (Level 1)	Observable Market Prices (Level 2)	Company Determined Market Prices (Level 3)
Financial assets:					
Cash and due from banks	$58,290	$58,290	$58,290	$—	$—
Securities available-for-sale	781,050	781,050	—	781,050	—
FHLB and Federal Reserve Bank stock	21,034	21,034	21,034	—	—
Trading account assets	2,300	2,300	2,300	—	—
Residential real estate loans	564,184	591,139	—	—	591,139
Commercial real estate loans	501,037	492,602	—	—	492,602
Commercial loans	183,680	179,519	—	—	179,519
Home equity loans	275,498	277,194	—	—	