BERKSHIRE HILLS BANCORP INC
Form 10-K
March 18, 2013
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

x	**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
	For the fiscal year ended: December 31, 2012
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: 000-51584

BERKSHIRE HILLS BANCORP, INC.

(Exact name of registrant as specified in its charter)

Delaware	**04-3510455**

(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
24 North Street, Pittsfield, Massachusetts	**01201**
(Address of principal executive offices)	(Zip Code)

Registrant s telephone number, including area code: **(413) 443-5601**

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of Exchange on which registered
Common stock, par value $0.01 per share	**New York Stock Exchange**

Securities registered pursuant to Section 12(g) of the Act: **None**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes o No x

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 (§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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of the Form 10-K or any amendment to this Form 10-K. x

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 definition of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

(Check one)

Large Accelerated Filer o	Accelerated Filer x
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 Act). Yes o No x

The aggregate market value of the voting and non-voting common equity held by non-affiliates was approximately $476 million, based upon the closing price of $22.00 as quoted on the NASDAQ Global Select Market as of the last business day of the registrant s most recently completed second fiscal quarter.

The number of shares outstanding of the registrant s common stock as of March 14, 2013 was 25,348,594.

DOCUMENTS INCORPORATED BY REFERENCE: Portions of the Proxy Statement for the 2013 Annual Meeting of Stockholders are incorporated by reference in Part III of this Form 10-K.

Table of Contents

INDEX

TABLE INDEX

Table of Contents

Table of Contents

PART I

ITEM 1. BUSINESS

FORWARD-LOOKING STATEMENTS

Certain statements contained in this document that are not historical facts may constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended (referred to as the Securities Act), and Section 21E of the Securities Exchange Act of 1934, as amended (referred to as the Securities Exchange Act), and are intended to be covered by the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. You can identify these statements from the use of the words may, will, should, could, would, pla potential, estimate, project, believe, intend, anticipate, expect, target and similar expressions. These forward-looking statements are significant risks, assumptions and uncertainties, including among other things, changes in general economic and business conditions, increased competitive pressures, changes in the interest rate environment, legislative and regulatory change, changes in the financial markets, and other risks and uncertainties disclosed from time to time in documents that Berkshire Hills Bancorp files with the Securities and Exchange Commission. Additionally, actual results from recent business combinations could differ materially from expected results, including difficulties in achieving cost savings from the merger or in achieving such cost savings within the expected time frame, along with difficulties in achieving targeted revenues from the merged operations. You should not place undue reliance on forward-looking statements, which reflect our expectations only as of the date of this report. We do not assume any obligation to revise forward-looking statements except as may be required by law.

GENERAL

Berkshire Hills Bancorp (Berkshire or the Company) is headquartered in Pittsfield, Massachusetts. Berkshire Hills Bancorp, Inc. is a Delaware corporation and the holding company for the Berkshire Bank (the Bank) and Berkshire Insurance Group (BIG). Established in 1846, the Bank is one of Massachusetts oldest and largest independent banks and is the largest banking institution based in Western Massachusetts.

Table of Contents

The Company profiles itself as follows:

During 2012, Berkshire transferred the listing of its common shares from NASDAQ to the New York Stock Exchange while retaining the trading symbol BHLB . At year-end 2012, Berkshire s closing stock price was $23.86 and 25.1 million common shares were outstanding. Berkshire is a regional bank and financial services company providing the service capabilities of a larger institution and the local focus and responsiveness as a local partner to its communities. The Company seeks to distinguish itself based on the following attributes:

- **Strong growth from organic, de novo, product and acquisition strategies**

- **Positive operating leverage elevating long term profitability**

- **Solid capital, core funding and risk management culture**

- **Experienced executive team focused on earnings and stockholder value**

- **Distinctive brand and culture as America s Most Exciting Bank**

- **Diversified integrated financial service revenues**

- **Positioned to be regional consolidator in attractive markets**

Table of Contents

The Bank operates under the brand America s Most Exciting Bank® and portrays its brand and culture as follows:

The Bank has 75 full-service banking offices and 10 lending offices in its New England and upstate New York footprint, which extends along Interstate 90 from Boston to Syracuse, and along Interstate 91 from Hartford into Vermont. The Bank s operations include those acquired as a result of four bank mergers in the last two years:

- Rome Bancorp, Inc. (Rome) in April 2011, headquartered in Rome, NY
- Legacy Bancorp, Inc. (Legacy) in July 2011, headquartered in Pittsfield, MA
- The Connecticut Bank and Trust Company (CBT) in April 2012, headquartered in Hartford, CT

- Beacon Federal Bancorp, Inc. (Beacon) in October 2012, headquartered in Syracuse, NY

The Bank s operations also include mortgage operations from Greenpark Mortgage Corporation (Greenpark) acquired in April 2012, headquartered in Needham, MA.

Table of Contents

The Bank serves the following regions:

- **Western New England**, with 27 banking offices, including the Company s headquarters in Pittsfield, MA. This region includes Berkshire County, MA, which is the Company s traditional market, where it has a leading market share in many of its product lines. This region also includes Southern Vermont, and many of the region s branches are in communities close to Route 7, which runs north/south through the valleys to the west of the Berkshire Hills and Green Mountains. This region is within commuting range of both Albany, New York and Springfield, Massachusetts and is known throughout the world as a tourist and recreational destination area, with vacation and second home traffic from New York City. The Pittsfield 2011 MSA GDP totaled $5 billion. At year-end 2012, the Company had approximately $1.3 billion in loans and $1.6 billion in deposits in its Western New England Market.

- **New York,** with 27 banking offices serving the Albany Capital District and Central New York. The Albany area represents a de novo expansion by the Company begun in 2005. Albany is the state capital and is part of New York s Tech Valley which is gaining prominence as a world technology hub including leading edge nanotechnology initiatives representing a blend of private enterprise and public investment. The Company s presence in this area is largely due to its de novo branch expansion, including four offices opened in 2012. The Company s Central New York area includes operations in the Rome/Utica MSA, which were acquired with the Rome merger, together with operations in the Syracuse MSA, which were acquired with the Beacon merger. The Albany/Schenectady 2011 MSA GDP was $41 billion, and the Rome/Utica/Syracuse total 2011 MSA GDP was $37 billion. At year-end 2012, including Beacon operations on a pro forma basis, Berkshire had approximately $1.4 billion in loans and $1.6 billion in deposits in the New York region. This included balances in two Tennessee branches which were part of the Beacon operations. Loans and deposits in these two branches were each less than $0.1 billion.

- **Hartford/Springfield,** with 20 banking offices serving the market along the Connecticut River in this region, which is the second largest economic area in New England. The Bank s operations here include operations acquired with the CBT merger in 2012. This region is centrally located between Boston and New York City at the crossroads of Interstate 91, which traverses the length of New England and Interstate 90, which traverses the width of Massachusetts. This region also has easy access to Bradley International Airport, which is a major airport serving central New England. The Hartford/Springfield combined 2011 MSA GDP was $107 billion. At year-end 2012, Berkshire had approximately $0.8 billion in loans and $0.8 billion in deposits in this region.

- **Eastern Massachusetts,** with ten lending offices and one branch office located in towns west and north of Boston. Eastern Massachusetts is the largest economic area in New England, and the Company s banking operations extend to Worcester which is within the commuting and commerce area of Boston. The Bank s Asset Based Lending Group is headquartered in this region, and serves middle market businesses throughout the Company s footprint. At year-end 2012, including the Beacon branch on a pro forma basis and all asset based loans, Berkshire had approximately $0.5 billion in loans and $0.1 billion in deposits in this region. Loans include residential mortgage loans in Eastern Massachusetts acquired from secondary market sources.

These regions are viewed as having favorable demographics and provide an attractive regional niche for the Bank to distinguish itself from larger super-regional banks and smaller community banks while serving its regional market area. The Company s markets have experienced less exposure to speculative development, real estate inflation, and subprime lending activities compared to many other regions of the country. As a result of its growth, the Company has increased and diversified its revenues both geographically and by product type and this has improved its flexibility in pursuing

Table of Contents

growth opportunities as they arise. The Company s regions have competitive economic strengths in precision manufacturing, distribution, technology, health care, and education which are expected to continue to support above average personal incomes and wealth. The Company believes it has attractive long term growth prospects because of the Bank s positioning as one of the leading regional banks in its markets with the ability to serve retail and commercial customers with a strong product set and responsive local management. The Company also has a goal to deepen its wallet share as a result of its focused cross sales program across its various business lines including insurance and wealth management. As a result of its bank acquisitions, the Company has a limited amount of loan and deposit business located outside of its New England and New York regional market which is not viewed as material to its condition, operations, and strategies.

In addition to business acquisitions, Berkshire s expansion has been based on team and talent recruitment. In 2012, this included the recruitment of the Eastern Massachusetts mortgage banking team, the recruitment of new commercial banking leadership in Hartford and Syracuse, and the integration of the Central/Eastern commercial team recruited in December 2011. The Company also pursues organic growth through ongoing business development, de novo branching, and product development. The Bank promotes itself as America s Most Exciting Bank®. It has set out to change the financial service experience. Its vision is to excel as a high performing market leader with the right people, attitude, and energy providing an engaging and exciting customer and team member experience. This brand and culture statement is expected to drive customer engagement, loyalty, market share and profitability. Similarly, this focus on performance underlies Berkshire s strong growth, improved efficiency, investment in infrastructure, and solid execution of acquisition due diligence and integration.

The Company offers a wide range of deposit, lending, insurance, and wealth management products to retail, commercial, not-for-profit, and municipal customers in its market areas. The Company s product offerings also include retail and commercial electronic banking, commercial cash management, and commercial interest rate swaps. The Company stresses a culture of teamwork and performance excellence to produce customer satisfaction to support its strategic growth and profitability. The Company utilizes Six Sigma tools to improve operational effectiveness and efficiency. The Company converted its core banking systems to a new scalable technology platform in 2012, with goals to enhance service, efficiency, reliability, customer relationship management, distribution channels, product quality, and revenue generation. The systems provide deeper and more granular customer and operational data that Berkshire expects to mine in order to better inform its strategic direction and business execution.

The Company has recruited executives with experience in regional bank management and has augmented its management team as it has expanded into a diversified regional financial services provider. The Company has invested in its infrastructure in order to position itself for further growth as a regional consolidator with an objective of filling in and expanding its footprint in its New England and New York markets. The Company completed four bank acquisitions in 2011 and 2012 which contributed strongly to accretion in earnings per share and which were absorbed while the Company also accreted tangible book value per share based on strong internal capital generation.

COMPANY WEBSITE AND AVAILABILITY OF SECURITIES AND EXCHANGE COMMISSION FILINGS

Information regarding the Company is available through the Investor Relations tab at www.berkshirebank.com. The Company s annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and any amendments to those reports filed pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 are available free of charge at www.sec.gov and at www.berkshirebank.com under the Investor Relations tab. Information on the website is not incorporated by reference and is not a part of this annual report on Form 10-K.

Table of Contents

COMPETITION

The Company is subject to strong competition from banks and other financial institutions and financial service providers. Its competition includes national and super-regional banks such as Bank of America, TD Bank, Citizens Bank, Sovereign Bank, and Key Bank which have substantially greater resources and lending limits. Non-bank competitors include credit unions, brokerage firms, insurance providers, financial planners, and the mutual fund industry. New technology is reshaping customer interaction with financial service providers and the increase of Internet-accessible financial institutions increases competition for the Company s customers. The Company generally competes on the basis of customer service, relationship management, and the fair pricing of loan and deposit products and wealth management and insurance services. The location and convenience of branch offices is also a significant competitive factor, particularly regarding new offices. The Company does not rely on any individual, group, or entity for a material portion of its deposits.

LENDING ACTIVITIES

General. The Bank originates loans in the four basic portfolio categories discussed below. Lending activities are limited by federal and state laws and regulations. Loan interest rates and other key loan terms are affected principally by the Bank s asset/liability strategy, loan demand, competition, and the supply of money available for lending purposes. These factors, in turn, are affected by general and economic conditions, monetary policies of the federal government, including the Federal Reserve, legislative tax policies and governmental budgetary matters. Most of the Bank s loans are made in its market areas and are secured by real estate located in its market areas. Lending is therefore affected by activity in these real estate markets. Loan portfolios acquired in business combinations include national commercial real estate loans acquired with Legacy and Tennessee commercial loans acquired with Beacon. The Company is reducing these acquired portfolios. The Bank does not engage in subprime lending activities targeted towards borrowers in high risk categories. The Bank monitors and manages the amount of long-term fixed-rate lending volume. Adjustable-rate loan products generally reduce interest rate risk but may produce higher loan losses in the event of sustained rate increases. In 2012, the Bank acquired residential mortgage banking operations in Eastern Massachusetts which primarily originate residential mortgages for sale. Excluding mortgage banking operations, the Bank retains most of the loans it originates, although the Bank generally sells its longer-term, fixed-rate, one to four-family residential loans and sometimes buys and sells participations in some commercial loans.

Loan Portfolio Analysis. The following table sets forth the year-end composition of the Bank s loan portfolio in dollar amounts and as a percentage of the portfolio at the dates indicated. Further information about the composition of the loan portfolio is contained in the Loans footnote in the consolidated financial statements.

Table of Contents

Item 1 - Table 1 - Loan Portfolio Analysis

	2012		2011		2010		2009		2008	
(In millions)	**Amount**	**Percent of Total**	**Amount**	**Percent of Total**	**Amount**	**Percent of Total**	**Amount**	**Percent of Total**	**Amount**	**Percent of Total**
Residential mortgages	$ 1,324.3	33%	$ 1,020.4	34%	$ 645.0	30%	$ 609.0	31%	$ 677.2	34%
Commercial mortgages	1,413.5	35	1,156.2	39	925.6	43	851.8	43	805.5	40
Commercial business	600.1	15	410.3	14	286.1	13	186.0	10	178.9	9
Total commercial loans	2,013.6	50	1,566.5	53	1,211.7	56	1,037.8	53	984.4	49
Consumer	650.7	17	369.6	13	285.5	14	314.8	16	345.5	17
Total loans	$ 3,988.6	100%	$ 2,956.5	100%	$ 2,142.2	100%	$ 1,961.6	100%	$ 2,007.1	100%
Allowance for loan losses	(33.2)		(32.4)		(31.9)		(31.8)		(22.9)	
Net loans	$ 3,955.4		$ 2,924.1		$ 2,110.3		$ 1,929.8		$ 1,984.2	

Residential Mortgages. The Bank offers fixed-rate and adjustable-rate residential mortgage loans with maturities of up to 30 years that are fully amortizing with monthly loan payments. Residential mortgages are generally underwritten according to the Federal National Mortgage Association (Fannie Mae) or the Federal Home Loan Mortgage Association (Freddie Mac) guidelines for loans they designate as A or A- (these are referred to as conforming loans). Private mortgage insurance is generally required for loans with loan-to-value ratios in excess of 80%. The Bank also originates loans above conforming loan amount limits, referred to as jumbo loans, which are generally conforming to secondary market guidelines for these loans. The Bank does not offer subprime mortgage lending programs.

The Bank generally sells most of its newly originated fixed rate mortgages. It also monitors its interest rate risk position and sometimes may decide to purchase or sell seasoned mortgage loans in the secondary mortgage market. The Bank is approved as a direct seller to Fannie Mae, retaining the servicing rights. Beginning in 2012, the Bank sells the majority of its mortgages to national institutional secondary market investors on a servicing released basis. Sales of mortgages generally involve customary representations and warranties and are nonrecourse in the event of borrower default. The Bank is also an approved originator of loans for sale to the Federal Housing Administration (FHA), U.S. Department of Veteran Affairs (VA), and state housing agency programs.

The Bank offers adjustable rate (ARM) mortgages which do not contain interest-only or negative amortization features. After an initial term of six months to ten years, the rates on these loans generally reset every year based upon a contractual spread or margin above the average yield on U.S. Treasury securities. ARM loan interest rates may rise as interest rates rise, thereby increasing the potential for default. At year-end 2012, the Bank s adjustable rate mortgage portfolio totaled $363 million. The Bank also originates loans to individuals for the construction and acquisition of personal residences. These loans generally provide fifteen-month construction periods followed by a permanent mortgage loan, and follow the Bank s normal mortgage underwriting guidelines.

Commercial Mortgages. The Bank originates commercial mortgages on properties used for business purposes such as small office buildings, industrial, healthcare, lodging, recreation, or retail facilities. This portfolio also includes commercial 1-4 family and multifamily properties.

Loans may generally be made with amortizations of up to 25 years and with interest rates that adjust periodically (primarily from short-term to five years). Most commercial mortgages are originated with final maturities of ten years or less. The Bank generally requires that borrowers have debt service coverage ratios (the ratio of available cash flows before debt service to debt service) of at least 1.25 times. Loans at origination may be made up to 80% of appraised value. Generally, commercial mortgages require personal guarantees by the principals. Credit enhancements in the form of additional collateral or guarantees are normally considered for start-up businesses without a qualifying cash flow history.

Table of Contents

Commercial mortgages generally involve larger principal amounts and a greater degree of risk than residential mortgages. They also often provide higher lending spreads. Because repayment is often dependent on the successful operation or management of the properties, repayment of such loans may be affected by adverse conditions in the real estate market or the economy. The Bank seeks to minimize these risks through strict adherence to its underwriting standards and portfolio management processes.

The Bank offers interest rate swaps to certain larger commercial mortgage borrowers. These swaps allow the Bank to originate a mortgage based on short-term LIBOR rates and allow the borrower to swap into a longer term fixed rate. The Bank simultaneously sells an offsetting back-to-back swap to an investment grade national bank so that it does not retain this fixed-rate risk. The Bank also records fee income on these interest rate swaps based on the terms of the offsetting swaps with the bank counterparties.

The Bank originates construction loans to builders and commercial borrowers in and around its markets. Construction loans finance the acquisition and/or improvement of commercial and residential properties. The maximum loan to value limits for construction loans follow FDIC supervisory limits, up to a maximum of 80%. The Bank commits to provide the permanent mortgage financing on most of our construction loans on income-producing property. Advances on construction loans are made in accordance with a schedule reflecting the cost of the improvements. Construction loans include land acquisition loans up to a maximum 65% loan to value on raw land. Construction loans may have greater credit risk than permanent loans. In many cases, the loan s repayment is dependent on the completion of construction and other real estate improvements, which entails risk that construction permits may be delayed or may not be received, or that there may be delays or cost overruns during construction. Repayment is also often dependent on the sale or rental of the improved property, which depends on market conditions and the availability of permanent financing. Developers and contractors may also encounter liquidity risks or other risks related to other projects which are not being financed.

Commercial Business Loans. The Bank offers secured commercial term loans with repayment terms which are normally limited to the expected useful life of the asset being financed, generally not exceeding seven years. The Bank also offers revolving loans, lines of credit, letters of credit, time notes and Small Business Administration guaranteed loans. Business lines of credit have adjustable rates of interest and are payable on demand, subject to annual review and renewal. Commercial business loans are generally secured by a variety of collateral such as accounts receivable, inventory and equipment, and are generally supported by personal guarantees. Loan to value ratios depend on the collateral type and generally do not exceed 95% of the liquidation value of the collateral. Some commercial loans may also be secured by liens on real estate. The Bank generally does not make unsecured commercial loans.

The Asset Based Lending Group serves the commercial middle market in New England, as well as the Bank s market in northeastern New York. This group expands the Bank s business lending offerings to include revolving lines of credit and term loans secured by accounts receivable, inventory, and other assets to manufacturers, distributors and select service companies experiencing seasonal working capital needs, rapid sales growth, a turnaround, buyout or recapitalization with credit needs ranging from $2 to $25 million. Asset based lending involves monitoring loan collateral so that outstanding balances are always properly secured by business assets.

In the fourth quarter of 2011, the Bank recruited an experienced commercial lending team to serve the commercial middle market in Central/Eastern Massachusetts. This team also has expertise in health care and education financing. Additionally, the Bank has reorganized its small business lending function to expand this important business financing capability and includes the retail division in the origination of conforming small business loans in order to provide the best service to community based small businesses.

Table of Contents

Commercial loans are of higher risk and are made primarily on the basis of the borrower s ability to make repayment from the cash flows of its business. Further, any collateral securing such loans may depreciate over time, may be difficult to monitor and appraise and may fluctuate in value. The Bank gives additional consideration to the borrower s credit history and the guarantor s capacity to help mitigate these risks.

Consumer Loans. The Bank s consumer loans consist principally of home equity lines of credit, together with second mortgage loans and automobile loans. The Bank s home equity lines of credit are typically secured by first or second mortgages on borrowers residences. Home equity lines have an initial revolving period up to fifteen years, followed by an amortizing term up to twenty years. These loans are normally indexed to the prime rate. Home equity loans also include amortizing fixed-rate second mortgages with terms up to fifteen years. Lending policies for combined debt service and collateral coverage are similar to those used for residential first mortgages, although underwriting verifications are more streamlined. The maximum combined loan-to-value is 80%. Home equity line credit risks are similar to those of adjustable-rate first mortgages, although these loans may be more sensitive to losses when interest rates are rising due to increased sensitivity to rate changes. Additionally, there may be possible compression of collateral coverage on second lien home equity lines. The Bank also includes all other consumer loans in this portfolio total, including personal secured and unsecured loans and overdraft protection facilities. The acquired Beacon operations include direct and indirect automobile loan portfolios. Beacon originated indirect automobile loans through established relationships with a number of automobile dealers in Central New York. For new automobiles, the amount financed could be up to 100% of the value of the vehicle, plus applicable taxes and dealer charges (i.e., warranty and insurance charges). For used automobiles, the amount of the loan was limited to the loan value of the vehicle, as established by industry guides.

Maturity and Sensitivity of Loan Portfolio. The following table shows contractual final maturities of selected loan categories at year-end 2012. The contractual maturities do not reflect premiums, discounts, deferred costs, and prepayments.

Item 1 - Table 2 - Loan Contractual Maturity -Scheduled Loan Amortizations are not included in the maturities presented.

Contractual Maturity (In thousands)	**One Year or Less**	**More than One to Five Years**	**More Than Five Years**	**Total**
Construction mortgage loans:				
Residential	$ 6,870	$ 19,849	$	$ 26,719
Commercial	64,752	103,073		167,825
Commercial business loans	171,817	326,681	101,628	600,126
Total	$ 243,439	$ 449,603	$ 101,628	$ 794,670

For the $551 million of loans above which mature in more than one year, $162 million of these loans are fixed-rate and $388 million are variable rate.

Loan Administration. Lending activities are governed by a loan policy approved by the Board s Risk Management Committee. Internal staff perform and monitor post-closing loan documentation review, quality control, and commercial loan administration. The lending staff assigns a risk rating to all commercial loans. Management primarily relies on internal risk management staff to review the risk ratings of the majority of commercial loan balances.

The Bank s lending activities follow written, non-discriminatory underwriting standards and loan origination procedures established by the Risk Management Committee and Management. The Bank s loan underwriting is based on a review of certain factors including risk ratings, recourse, loan-to-value ratios and material policy exceptions. The

Table of Contents

Risk Management Committee has established individual and combined loan limits and lending approval authorities. Management s Executive Loan Committee is responsible for commercial and residential loan approvals in accordance with these standards and procedures. Generally, commercial lending management has the authority to approve pass rated secured loans up to $2 million and in conjunction with the Senior Credit Officer up to $7.5 million (or $5 million in the case of material policy exceptions). The Executive Loan Committee approves secured loans over these amounts (and over $1 million unsecured).

The Bank s lending activities are conducted by its salaried and commissioned loan personnel. Designated salaried branch staff originate conforming residential mortgages and receive bonuses based on overall performance. Additionally, the Bank employs commissioned residential mortgage originators. Commercial lenders receive salaries and are eligible for bonuses based on overall performance. From time to time, the Bank will purchase whole loans or participations in loans. These loans are underwritten according to the Bank s underwriting criteria and procedures and are generally serviced by the originating lender under terms of the applicable participation agreement. The Bank routinely sells newly originated fixed rate residential mortgages in the secondary market. Customer rate locks are offered without charge and rate locked applications are generally committed for forward sale or hedged with derivative financial instruments to minimize interest rate risk pending delivery of the loans to the investors. The Bank sells a limited number of commercial loan participations on a non-recourse basis. The Bank issues loan commitments to its prospective borrowers conditioned on the occurrence of certain events. Loan origination commitments are made in writing on specified terms and conditions and are generally honored for up to sixty days from approval; some commercial commitments are made for longer terms.

The loan policy sets certain limits on concentrations of credit and requires periodic reporting of concentrations to the Risk Management Committee. Loans outstanding to the ten largest relationships averaged $23 million each, or 5.1% of total risk based capital. Total year-end commercial construction loans outstanding were 37% of the Bank s risk based capital at year-end, and total commercial mortgage outstandings (including certain owner-occupied loans) were estimated at 272% of risk based capital. The Bank s portfolio management objective has been to reduce these concentrations. The FDIC has established monitoring guidelines of 100% and 300% for these ratios, respectively. Above these guidelines, additional monitoring and risk management controls are required.

Problem Assets. The Bank prefers to work with borrowers to resolve problems rather than proceeding to foreclosure. For commercial loans, this may result in a period of forbearance or restructuring of the loan, which is normally done at current market terms and does not result in a troubled loan designation. For residential mortgage loans, the Bank generally follows FDIC guidelines to attempt a restructuring that will enable owner-occupants to remain in their home. However, if these processes fail to result in a performing loan, then the Bank generally will initiate foreclosure or other proceedings no later than the 90th day of a delinquency, as necessary, to minimize any potential loss. Management reports delinquent loans and non-performing assets to the Board quarterly. Loans are generally removed from accruing status when they reach 90 days delinquent, except for certain loans which are well secured and in the process of collection. Delinquent automobile loans are maintained on accrual until they reach 120 days delinquent, and then they are generally charged-off.

Real estate acquired by the Bank as a result of loan collections is classified as real estate owned until sold. When property is acquired it is recorded at fair market value less estimated selling costs at the date of foreclosure, establishing a new cost basis. Holding costs and decreases in fair value after acquisition are expensed. Interest income that would have been recorded for 2012 if nonaccruing loans been current according to their original terms, amounted to $1.5 million. Included in the amount is $19 thousand related to troubled debt restructurings. The amount of interest income on those loans that was recognized in net income in 2012 was $0.3 million. Included in this amount is $43 thousand

Table of Contents

related to troubled debt restructurings. Interest income on accruing troubled debt restructurings totaled $0.1 million for 2012. The total carrying value of troubled debt restructurings was $4.6 million at year-end.

The following table sets forth additional information on year-end problem assets and accruing troubled debt restructurings (TDR). Due to accounting standards for business combinations, non-accrual loans of acquired banks are recorded as accruing on the acquisition date. Therefore, measures related to accruing and non-accruing loans reflect these standards and may not be comparable compared to prior periods.

Item 1 - Table 3 - Problem Assets and Accruing TDR

(In thousands)	**2012**	**2011**	**2010**	**2009**	**2008**
Non-accruing loans:					
Residential mortgages	$ 7,466	$ 7,010	$ 2,173	$ 3,304	$ 1,646
Commercial mortgages	12,617	14,280	9,488	31,917	7,738
Commercial business	3,681	990	1,305	3,115	1,921
Consumer	1,748	1,954	746	364	866
Total non-performing loans	25,512	24,234	13,712	38,700	12,171
Real estate owned	1,929	1,900	3,386	30	498
Total non-performing assets	$ 27,441	$ 26,134	$ 17,098	$ 38,730	$ 12,669
Troubled debt restructurings (accruing)	$ 3,641	$ 1,263	$ 7,829	$ 17,818	$ 7,456
Accruing loans 90+ days past due	$ 18,977	$ 10,184	$ 1,054	$ 91	$ 923
Total non-performing loans/total loans	0.64%	0.82%	0.64%	1.97%	0.61%
Total non-performing assets/total assets	0.52%	0.65%	0.59%	1.43%	0.48%

Asset Classification and Delinquencies. The Bank performs an internal analysis of its commercial loan portfolio and assets to classify such loans and assets in a manner similar to that employed by the federal banking regulators. There are four classifications for loans with higher than normal risk: Loss, Doubtful, Substandard and Special Mention. Normally an asset classified as Loss is fully charged-off. Substandard assets have one or more defined weaknesses and are characterized by the distinct possibility that the insured institution will sustain some loss if the deficiencies are not corrected. Doubtful assets have the weaknesses of substandard assets with the additional characteristic that the weaknesses make collection or liquidation in full on the basis of currently existing facts, conditions and values questionable, and there is a high possibility of loss. Assets that do not currently expose the insured institution to sufficient risk to warrant classification in one of the aforementioned categories but possess weaknesses are designated Special Mention. Please see the additional discussion of non-accruing and potential problem loans in Item 7 and additional information about loans by risk rating in the Loans Note to the consolidated financial statements.

Allowance for Loan Losses. The Bank s loan portfolio is regularly reviewed by management to evaluate the adequacy of the allowance for loan losses. The allowance represents management s estimate of inherent losses that are probable and estimable as of the date of the financial statements. The allowance includes a specific component for impaired loans (a specific loan loss reserve) and a general component for portfolios of all outstanding loans (a general loan loss reserve). There is no allowance for loan losses assigned at the time of acquisition to loans acquired in business combinations which are carried at fair value, including the impact of expected losses, as of the acquisition date. An allowance on such loans is established subsequent to the acquisition date through the provision for loan losses based on an analysis of factors including environmental factors. The loan loss allowance is discussed further in the Note about Significant Accounting Policies in the consolidated financial statements.

Table of Contents

For loans covered by the loan loss allowance, management assesses specific loan loss reserves when it deems that it is probable that the Bank will be unable to collect all amounts due according to the contractual terms stipulated in the loan agreement. Management weighs various factors in its assessment, including but not limited to, its review of the borrower s payment history and the borrower s future ability to service the debt, the current value of any pledged collateral, and the strength of any guarantor support. Generally non-accruing commercial loans are deemed impaired and evaluated for specific valuation allowances. Confirmed loan losses are charged-off directly to the allowance. Losses are deemed confirmed when upon review of all the available evidence, any portion of the loan balance is deemed uncollectible. Subsequent recoveries, if any, are credited to the allowance.

For loans from business activities covered by the loan loss allowance, management estimates general loan loss reserves when it is probable that there would be credit losses in portfolios of loans with similar characteristics. Management has identified four primary loan portfolios: residential mortgages, commercial mortgages, commercial business, and consumer loans. Sub-portfolios within these primary loan portfolios are also evaluated in order to arrive at a more precise general loan loss allowance. The methodology includes a historical loss component and an environmental factors component. The historical loss component is based on the Bank s risk rating system in combination with the attribution of loss factors based on corporate default and recovery rates in the industry. The environmental factors component assesses loss potential as it may be affected by economic business conditions, lending policies and procedures, portfolio characteristics, management and staff changes, problem loan trends, and credit concentration trends. While the general loss reserve is analyzed according to the various subportfolios, the general loss reserve in aggregate is available to cover all losses in all components of the loan portfolio.

Management believes that it uses the best information available to establish the allowance for loan losses. However, future adjustments to the allowance for loan losses may be necessary, and results of operations could be adversely affected if circumstances differ substantially from the assumptions used in making its determinations. Because the estimation of inherent losses cannot be made with certainty, there can be no assurance that the existing allowance for loan losses is adequate or that increases will not be necessary should the quality of any loan or loan portfolio category deteriorate as a result of the factors discussed above. Additionally, the regulatory agencies, as an integral part of their examination process, also periodically review the Bank s allowance for loan losses. Such agencies may require the Bank to make additional provisions for estimated losses based upon judgments different from those of management. Any material increase in the allowance for loan losses may adversely affect the Bank s financial condition and results of operations.

Table of Contents

The following table presents an analysis of the allowance for loan losses for the years indicated.

Item 1 - Table 4 - Allowance for Loan Loss

(In thousands)	**2012**	**2011**	**2010**	**2009**	**2008**
Balance at beginning of year	$ 32,444	$ 31,898	$ 31,816	$ 22,908	$ 22,116
Charged-off loans:					
Residential mortgages	2,647	1,322	409	2,016	143
Commercial mortgages	4,229	4,046	6,403	27,596	1,384
Commercial business	697	1,443	2,685	5,945	884
Consumer	1,877	885	1,188	3,586	2,031
Total charged-off loans	9,450	7,696	10,685	39,143	4,442
Recoveries on charged-off loans:					
Residential mortgages	103	231	213		
Commercial mortgages	52	189	794	22	100
Commercial business	96	109	1,094	64	290
Consumer	373	150	140	235	264
Total recoveries	624	679	2,241	321	654
Net loans charged-off	8,826	7,017	8,444	38,822	3,788
Allowance attributed to loans acquired by merger					
Provision for loan losses					